

DECEMBER 1961

VOL. XXXI No. 12

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Development Program"**

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A National Survey and
Critique
(Second and Concluding
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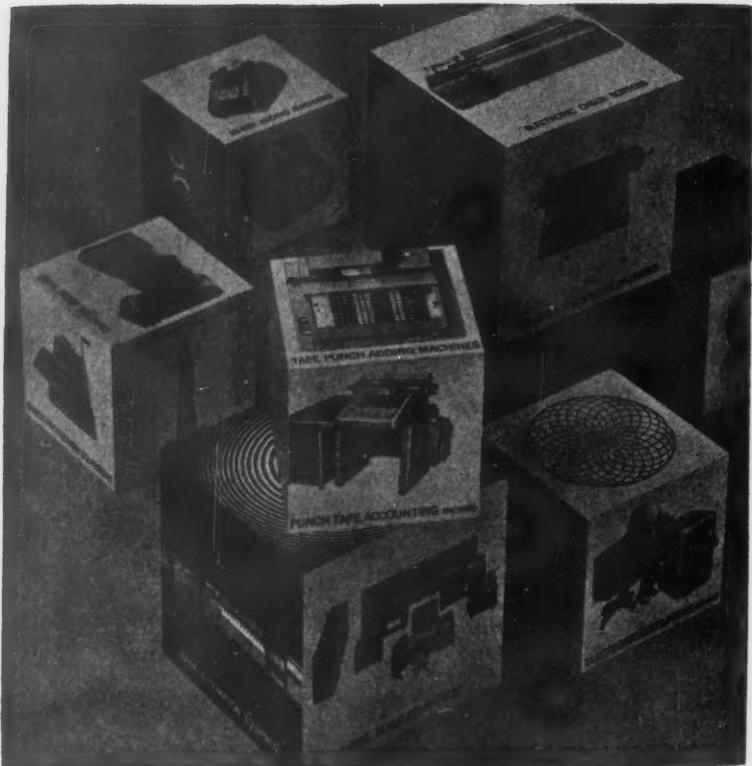
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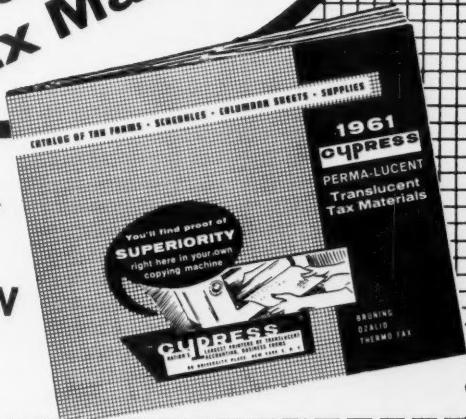
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Accounting News and Trends

INCORPORATION OF ACCOUNTING FIRMS IN FLORIDA

The Florida State Board of Accountancy has issued a statement with respect to incorporation by CPAs. As reported in *The Florida CPA News Notes* (October 1961), the State Board, at a meeting in Gainesville on September 15, adopted a policy indicating that it has no intention at this time of amending its Rule C-16 which prevents any person licensed by the Board from practicing as a corporation or part of a corporation. This action followed passage of the Professional Service Corporation Act by the 1961 Florida Legislature.

GENERAL AUDITING PRINCIPLES ADOPTED BY ENGLISH ACCOUNTANTS

The issuance by the Institute of Chartered Accountants in England and Wales of the first of a series of *Statements on Auditing* represents an entirely new idea (*Accountancy*, August 1961). There have been *Recommendations on Accounting Principles*, publications on professional conduct and various technical statements, but never before has the Institute attempted to lay down general principles of auditing. Parts of this statement may be of particular interest to American CPAs:

Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is Program Director of the Brooklyn Chapter of the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.

On matters of internal control, the Statement is forthright. It underlines the responsibilities of directors for the accounts and financial control of the company and their statutory duties to see that adequate records are kept and that annual accounts disclose the true and fair view required by the 1948 Companies Act. It points out that the auditors cannot protect them from any shortcomings in carrying out these responsibilities. And it gives the warning that, if the directors do not carry out their duty properly, not only may this influence the terms of the auditors' report but that the auditors may be involved in abnormally extensive checking, at the expense of the company.

Throughout, the Statement emphasizes that the auditors cannot and should not function as a substitute for proper management control. However, it is the auditors' function to see that a proper system of internal control exists. By "internal control" is meant not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.

Extensive detailed checking is no substitute for a proper review of internal control. In fact, auditors are recommended "to reduce their detailed checking to a minimum consistent with the system of internal control and the state in which they find the records. If their inquiries and tests satisfy them that the system is sound in principle

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and is carried out in practice then no useful purpose is served by extensive detailed checking." The suggestion of the Statement is, therefore, that audit procedures should be based primarily on an appropriate series of tests designed to satisfy the auditors that the system of internal control is properly operated and is effective, so that the records can be regarded as a reliable basis for the preparation of accounts.

Examinations "in depth," on which the Statement puts emphasis, involve tracing a transaction through its various stages from origin to conclusion; examining at each stage to an appropriate extent the vouchers, records and authorities relating to that stage; and observing the incidence of internal check and delegated authority.

In addition to the normal annual audit procedures covering all activities, it is considered sound practice to select each year, for a more intensive review, one of the main aspects of the activities of the business—for example, sales, wages, or payments to suppliers.

An editorial on this topic in the same issue contains this thought-provoking comment: "Auditing, though a main occupation of the professional accountant, has for too long been neglected as a subject for new thought."

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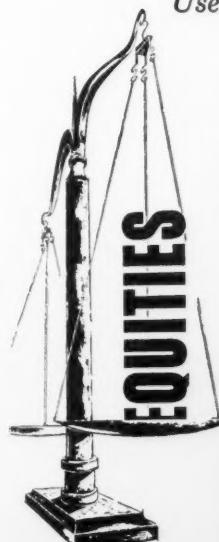
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THE PRESIDENT'S PAGE

A Professional Development Program

It is recognized in every profession that there is a need for study and for professional development, in addition to what one has learned in college. The complexities, the very size of business and government, have increased the importance of accounting, as for example in reporting to stockholders, in the determination of tax liabilities, in rate regulation matters, estate planning, specialized audits such as welfare funds and labor unions, electronic data processing, budgets and many other areas. Thus new responsibilities have been imposed on accountants and we must keep abreast of new developments and techniques in these and many other areas.

We have tried to meet these demands, in our Society, chiefly through the activities of our technical committees and our technical journal. But with the growing demands upon our profession, the ever increasing opportunities to assist our clients, business and government, many accountants in recent years have made it evident that a more formalized program of professional development was needed.

Other professions have such professional development educational programs—law, medicine and also business through, for example, the American Management Association. (It has even been suggested that accounting has been lagging behind other professions in this respect.)

During the past summer, our Committee on Professional Development gave a great deal of thought to the problem of professional development. It finally unanimously agreed, after several meetings, that there is a genuine need for such a program in this State and that its conduct is a proper function of our Society.

It was also the unanimous opinion of the Commit-

tee that in order to successfully conduct such a program, it would be necessary for the Society to engage an individual who would have, as his primary responsibility, the direction of such program.

The above recommendations of the Committee were presented by its Chairman to the Board at the October meeting, and after a full and thorough discussion, were unanimously approved by the Board.

To carry out this directive we have been most fortunate in obtaining the services of Dr. Francis K. Ballaine, formerly Dean of Adelphi College and Director of its Executive Development Program, to develop and coordinate this program. He has been working on the preliminary phase since the middle of October.

Our technical committees have for many years done an outstanding job in presenting programs within their respective areas, including (during the past two years) seminars using material furnished by the American Institute of CPA's. It is our intention that the committees will continue their work as at present, as a part of our over-all professional development program.

In addition, we will use new courses developed by the American Institute. Several are now operative, covering such subjects as Budgeting, Preparation of Reports, Tax Planning, Generally Accepted Auditing Standards, Staff Training, and the so-called "bread and butter" courses—Accountants' Fees and Building an Accounting Practice. The courses run from one to four days. Eight others are in various stages of completion. Eventually we will undoubtedly develop courses of our own to fill the special needs of the profession in this State. We may even go farther afield in the future, to include subjects related to the broader knowledge of an accountant, such as economics, foreign trade, etc.

While our younger CPA's will find this program a means of increasing their professional stature, many of our more mature members will find some portions of it helpful as refresher courses. It is intended that the program will be self-supporting, and that the participants will assume its modest costs. However, due to "start-up" expenses, it will run in the red this year and perhaps next year also.

This Professional Development Program, under the sponsorship of our Society, will undoubtedly be an important factor in the future growth of the accounting profession in New York State. It should help all of us to keep abreast of the tremendous potential which lies ahead for certified public accountants as we enter the electronic age and move ever closer to our function as business advisors to top management.

EDWARD J. BUEHLER,
President

Legal Dividend Sources— A National Survey and Critique

SECOND AND CONCLUDING PART

By STEPHEN A. ZEFF, PH.D.

EARNED-SURPLUS STATES

Due principally to the promulgation of the Model Act, the earned-surplus test has become the most restrictive criterion for ordinary dividends in 19 states. For purposes of analysis, these states may be divided into (1) those having Model Act language in their dividend sections, and (2) those not utilizing Model Act language but nonetheless restricting ordinary dividends to earned surplus.

Model Act States. (See Table C for the states in this category.) The Model Act, in its Section 40(a), provides that ordinary dividends may emanate from "unreserved and unrestricted earned surplus" in the absence of existing and resulting equity insolvency. Earned surplus may be "reserved," per Section 64, at the discretion of the directors; it is "restricted," according to Section 5 of the Act, to the extent that it is used as a measure of the corporation's ability to acquire its own shares.

Notice dividends may be paid in accord with the terms of Section 41. Such dividends may be paid out of capital surplus to preferred stockholders in satisfaction of their cumulative dividend rights—but only if (1) there is no earned surplus, and (2) existing and resulting equity insolvency are not present.

A notice dividend may be paid from capital surplus on all classes of stock only if the following conditions are met:

1. Either:
 - a. the articles of incorporation so permit; or
 - b. the stockholders, by at least a two-thirds majority, expressly approve;
2. Existing and resulting equity insolvency are absent;
3. All cumulative dividend rights of preferred stockholders have been satisfied; and
4. Its payment does not reduce the remaining net assets below the aggregate preferential amount payable in voluntary liquidation to shares having such a preferential claim on assets. (This condition shall hereinafter be referred to as the "assets-preference clause.")

(Although one can argue that the nature of these four conditions, especially number one, disqualifies such a distribution as a "dividend," it will be assumed here that it does meet the test of a dividend.) Prior to certain 1959 revisions, Model Act Section 41 applied these four conditions to the payment of notice dividends from stated capital as well as from capital surplus. Alaska, North Dakota, Ore-

gon, and Wisconsin adopted Section 41 in this earlier form, although "stated capital" has since been deleted from Model Act Section 41 itself. Connecticut, Utah, and Virginia use Section 41 only for notice dividends from capital surplus. Alabama makes no provision for notice dividends. Pennsylvania requires a special stockholder vote in all cases to approve notice dividends from capital surplus, whereas Texas allows notice dividends from capital surplus (but not from reduction surplus) without either a charter provision or stockholder vote.²⁷

In seven of the nine states allowing notice dividends of some sort, the notice may disclose only that the payment represents a "partial liquidation,"²⁸ the recommendation of the pre-1959 Model Act Section 41. Virginia and Connecticut, in harmony with the current status of Model Act Section 41, require disclosure of the source alone. It is evident, therefore, that although these 10 states are in substantial accord with the Model Act as to ordinary dividends, their conceptions of the circumstances that should permit notice dividends remain at odds. Alabama is too restrictive in not providing for notice dividends at all. Pennsylvania may be too stringent in requiring a stockholder vote for any notice dividend. A vote seems to be necessary only if, say, more than half of the capital surplus is to be distributed.

Elimination of Deficits. Except for a paragraph in Section 64, the Model Act philosophy of an ordinary dividend is clearly that of an earnings distribution. Because the typical outsider interprets a dividend, in the absence of notice to the contrary, as a disposition of earnings, the Model Act allows the innocent recipient or onlooker to draw safe inferences.

But Section 64 permits directors to apply

"... any part or all of its capital surplus to the reduction or elimination of any deficit arising from losses, however incurred, but only after first eliminating the earned surplus...."

No notice need be given to stockholders either at the time of the offset or at the time of a later dividend from subsequently-accumulated earned surplus. For example, DEF Corporation has \$10,000 of earned surplus and \$150,000 of capital surplus. At the end of the next fiscal year, the period's net loss is found to be \$25,000. A Section-64 quasi-reorganization would leave a capital surplus of \$135,000. If a \$30,000 net income accrues during the second year, it all may be paid as an ordinary dividend. Only if there is full disclosure of the facts as to the quasi-reorganization, in accordance with the disclosure standard of ARB 46, will the stockholders and others who receive the financial statements be put on notice properly.

Normally, i.e., without a quasi-reorganization, the \$15,000 deficit would diminish the earliest subsequent profits. But Section 64, by itself, permits abnormal accounting (the accounting for a quasi-reorganization is, after all, nothing more than a 'suspension of the rules') to be advertised as though it were normal, leading to the conclusion by outsiders that the dividends emanate from earnings as normally measured.

Alaska, Colorado, Connecticut, Maryland, North Dakota, Oregon, Texas, Wisconsin, and Wyoming have adopted this paragraph of Section 64. Virginia added a notice requirement in 1959. California, as an example of a non-Model Act state, requires notice in the "annual statement" and at the next annual meeting, following a quasi-reorganization. Pennsylvania provides that earned surplus be "dated" for 10 years thereafter. The New York law (effective April 1, 1963) not only requires stockholder approval of such

action, but also outlines a procedure for informing stockholders and other readers of financial statements. Section 64 of the Model Act should be revised to require proper disclosure, at the least.²⁹

Unique to the Model Act is its definition of earned surplus:³⁰

"... the portion of the surplus . . . equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus."

The terms "net profits," "income," "gains," and "losses" are nowhere defined in the Model Act or in the states that have adopted this definition. Standards for their determination are also absent. One must look to the section of the Model Act that spells out the ways in which directors can escape liability for improper distributions—a subject that is treated below—in order to breathe any meaning into these terms.

Alabama, Alaska, Connecticut, North Dakota, Oregon, Utah, and Wisconsin accept the Model Act definition. Virginia omits "income, gains and losses," and Texas (significantly) adds "realized" prior to "gains and losses"; otherwise, these two states also follow the Model Act definition. Pennsylvania, however, prefers not to define the term, letting earned surplus be the difference between surplus (defined) and capital surplus (defined). (The Model Act does just the reverse, letting capital surplus be the difference between surplus (defined) and earned surplus (defined)).

Other Earned-Surplus States. Nine³¹

other states, using a diversity of language, also restrict ordinary dividends to earned surplus. They vary among themselves mainly in their handling of capital surplus.

In addition to the data contained in Table D, District of Columbia, Illinois, Maryland, and Michigan have provisions roughly comparable to Section 41 (exclusive of the paragraph allowing notice dividends rights in satisfaction of cumulative dividend rights) of the Model Act. District of Columbia, however, makes the provision applicable to distributions from stated capital as well, also requiring in such instances a two-thirds majority approval of the stockholders.

Hawaii has probably the most borderline provision of the nine states. It permits ordinary dividends from "profits and earned surplus" (neither term being defined), only when there is no existing and resulting capital impairment. There is no notice-dividend provision. Conceivably, "profits" could be construed to mean "annual profits," but the usual legal usage of this term would probably work against such a result. If "profits" is to mean the same as surplus, why is earned surplus mentioned at all? And why is capital impairment prescribed as a limitation? Use of the connective, "and"—as opposed to the usual "or"—seems to suggest here that no alternative is intended; indeed, it appears that the terms are meant to be synonyms. The capital-impairment limitation is most likely used only for assurance that no misconstruction of "profits and earned surplus" will lead to capital impairment.

Criticisms of The Model Act. The 19 states having the earned-surplus test as their most liberal (and sole) criterion for ordinary dividends constitute the core of what deserves to be the majority rule. Dividends paid on

this basis are probably the least likely to injure creditors, disfranchise different classes of stockholders of their rights *inter se*, and confuse and mislead laymen and other interested parties.

As to notice dividends, when earned surplus is the sole source of ordinary dividends, the Model Act section is in one respect too liberal, and in another respect too conservative. First, the required notice should disclose the source as well as the circumstances attending the distribution (if the latter have not already been divulged to interested parties). It is submitted that disclosure, to be effective, must include reasons as well as facts. A notice dividend is ipso facto not a distribution in the normal course, and the stockholders should be informed of the nature of the abnormal course that the directors have chosen to follow.

Second, Model Act Section 41 should not require either a charter provision or special stockholder vote for all distributions of capital surplus. Comparatively small disbursements of capital surplus should be left to the discretion of the directors; relatively large proposed distributions of capital surplus, however, should warrant stockholder approval. Without this minor relaxation, undesirable lawsuits might be produced as a result of harmless and petty invasions of capital surplus made for the purpose of cushioning cyclical earnings movements.

Finally, as discussed above, Section 64 (on quasi-reorganizations) needs a tightening up.

CAPITAL-IMPAIRMENT STATES

One of the oldest dividend criteria, that of capital impairment, is used by 11 states (the major features of the dividend provisions of which are summarized in Table E) as their most liberal test for ordinary dividends. These states either stipulate that ordi-

nary dividends may be paid only out of the excess (or surplus) of net assets over capital, or they merely provide, sometimes ambiguously, that dividends may not be paid out of capital.

Four of these states also use the insolvency test. Although two do not define the term, equity insolvency is probably intended, for a capital-impairment clause would also operate to preclude dividend payments in all instances in which liabilities exceed assets—making superfluous a *bankruptcy* insolvency test. Indeed, equity insolvency may occur prior to the time of capital impairment. In certain circumstances, therefore, the former may be the more restrictive measure (vis-a-vis capital impairment) of ordinary dividends in such states.³²

The phraseology among the capital-impairment states varies. In Maine, "dividends of profit" may not be paid out of capital "until all debts due from the corporation are paid." Arizona and South Dakota prohibit dividends except from "surplus profit(s) arising from the business"—a phrase that dates back to the New York act of 1825. Although "surplus profits" probably would connote earned surplus to accountants, it appears that the preponderance of legal authority equates it with surplus. It should be noted that Kentucky, Maine, and Mississippi forbid a dividend that would "diminish," "reduce," or "withdraw" capital. No positive source, such as surplus, is expressly given in these states. Conceivably, dividends made from current net earnings in the face of an already-existing capital impairment would be valid according to a literal reading of these states' provisions. New York (current) and Vermont are careful to state that a dividend is permissible only if, after its payment, the sum of liabilities and capital is no greater than the value of the assets.

Iowa also has a "partial liquidation" section similar to section 41 (omitting the paragraph that allows notice dividends out of capital surplus in satisfaction of cumulative dividend rights). Unlike the Model Act, however, Iowa's notice-dividend section apparently relates to distributions from stated capital, for that state allows ordinary dividends from "unreserved surplus." Colorado is much like Iowa; indeed, the former explicitly provides that its version of Model Act section 41 applies to distributions from stated capital. Colorado—a similar provision exists in Pennsylvania—uses an assets-preference clause as a general limitation on all ordinary dividends.³³ Such a clause also appears in the Model Act, but only in respect of notice dividends paid other than in satisfaction of cumulative dividend rights.

Accounting Authorities' Views. Leading accounting writers have spoken out against the payment of ordinary dividends from capital surplus. Montgomery once wrote that the payment of such a dividend "comes close to moral turpitude."³⁴ Paton has written that such a dividend "deserves the general condemnation accorded by accountants" and that "[i]t is deplorable that this condition is given legal sanction."³⁵ Kohler would insist upon a stockholder vote before distributing capital surplus.³⁶ Finney and Miller believe that the "ethics of business management" may call for the stockholders to be informed of the dividend source, if it is not earned surplus.³⁷

It cannot be denied that the commonly understood source of ordinary dividends is earned surplus, usually the current portion thereof. But this should not prevent directors from paying dividends in exceptional circumstances from other sources. The requirement of a stockholder vote for non-earned surplus distributions would be a wooden restriction in an area in

which a fair amount of discretion should be allowed to directors. But legislators should not grant these alternative sources carte blanche.

It will be pointed out below that the Securities and Exchange Commission wisely allows directors of public utility holding companies to declare an occasional preferred dividend (with notice of the source) out of capital surplus—if certain conditions are met.

Distributions from capital surplus or from current net earnings amidst a capital impairment should be permitted only as stopgap measures. Where ordinary dividends are limited to earned surplus, as they should be, notice dividends should be available as an expeditious escape from temporarily awkward situations. The practice of allowing earned surplus to accumulate while dividends (with or without notice) are draining capital surplus should not be countenanced.

MAVERICKS: MASSACHUSETTS AND NEW HAMPSHIRE

Massachusetts employs both definitions of insolvency as its only dividend test. Its dividend provision has been altered only once since 1830. That was in 1903, when, five years after passage of the National Bankruptcy Act, the Massachusetts legislature replaced "insolvent" by "bankrupt or insolvent."

New Hampshire has a strange dividend provision; it makes one reflect a good deal before he can understand its meaning.

It follows:

"... [N]o dividend shall be paid to, and no part of its capital stock shall be withdrawn by, or refunded to, any of its stockholders, when its property is insufficient or will be thereby rendered insufficient for the payment of all its debts."³⁸

Odd as it may seem, ordinary dividends may come from *any* source if

they do not result in equity insolvency. And even if the firm's ability to meet its debts is thereby endangered, ordinary dividends may still (somehow) be paid from other than capital.

To be sure, the dividend provisions of these two New England states are as liberal as any that can be found in this country.

THE INSOLVENCY TEST FOR DIVIDENDS

Twenty-eight states excluding New York (eff. 4/1/63) expressly prohibit one or more kinds of dividends if insolvency is attendant. In 15 of the states, equity insolvency is, by statutory definition, the only type of insolvency that is meant. In Minnesota alone, bankruptcy insolvency is, again by statutory definition, the only kind of insolvency intended.

Both senses of insolvency are called for explicitly in California, Connecticut, Maryland, Massachusetts, North Carolina, and Oklahoma. In six states, insolvency is left undefined.

Contrary to Littleton's argument,³⁹ statutory policy should not permit dividend payments to interfere with the normal operations of corporate going concerns.

THE AVAILABILITY OF APPRECIATION SURPLUS

A large majority of states are silent as to their statutory policy on the includability of surplus arising from unrealized appreciation of assets (appreciation surplus) in the source or sources available for ordinary dividends. And comparatively few courts have given opinions directly in point.

In the most noted American case on this question, *Randall v. Bailey*,⁴⁰ three New York courts unanimously agreed that the dividend provision of that state, in the light of New York statutory history, (in effect) permitted directors to revalue assets for purposes of determining the funds available for dividends. Although the contested pro-

vision is still extant in New York and the principle has not since been overturned by the New York judiciary, the newly passed New York Corporation Law, effective April 1, 1963, expressly excludes appreciation surplus as a source of ordinary dividends.

But *Randall v. Bailey* will not have lost its influence, for a Delaware court in 1949 quoted approvingly from the *Randall* decision in the often overlooked case of *Morris v. Standard Gas & Electric Co.*⁴¹ In the *Morris* Case, the court said that directors are required "... to evaluate the assets on the basis of acceptable data and by standards which they are entitled to believe reasonably reflect present 'values.'"⁴² One may query whether several of the current-net-earnings states that have patterned their dividend provisions after the Delaware model will adopt the *Morris* philosophy. Legal writers in these and other states have occasionally expressed concern lest their states also include appreciation surplus as a source.⁴³

Twelve statutes expressly and unequivocally exclude surplus arising from unrealized appreciation of assets as a source of ordinary dividends:

	California	Michigan
Idaho		New York (eff. 4/1/63)
Illinois		Ohio
Indiana		Pennsylvania
Iowa		Texas
Louisiana		Washington

Of these, Illinois, Louisiana, and Ohio similarly exclude appreciation surplus as a source of notice dividends. Idaho (dividends in property only), Louisiana, and Washington (dividends in property only) relax the prohibition to allow ordinary dividends from the increase in market value of readily marketable securities. Idaho, Louisiana, and Washington—showing the influence of the old Uniform Act—treat at some length the ineligibility of

certain unrealized and unearned gains. Michigan permits ordinary dividends to be paid from booked increases only to the extent that they restore earlier bookings of unrealized decreases—when both affect earned surplus.

No state statute expressly and unequivocally authorizes ordinary dividends from unrealized appreciation of fixed assets.

Minnesota and Oklahoma exclude appreciation surplus (in Minnesota, only on fixed assets) from the computation of earned surplus and paid-in surplus. But both are silent on its relation to current net earnings. Presumably, such appreciation surplus may not be credited to current net earnings as well. Only a literal and narrow reading of the statute would produce a contrary result.

North Carolina, another current-net-earnings state, expressly excludes appreciation surplus from the calculation of earned surplus. Appreciation surplus is not specifically excluded from net profits, although the language in other corporation-finance sections of the statute seems to suggest that net profits would also be free from the effect of write-ups.

The Model Act states, save for Pennsylvania and Texas, have not declared a clear position relative to appreciation surplus. In the absence of an appreciation-surplus clause, one must look to the section in the statute that enumerates the directors' liability for improper acts—more specifically to the ways in which directors can escape liability. Twenty-three states have already adopted an exoneration clause which approximates that of Model Act Section 43(e) para. 3, which reads:

"A director shall not be liable under subparagraphs (a), (b) or (c) of this section if he relied and acted in good faith upon financial statements of the corporation repre-

sented to him to be correct by the president or the officer of such corporation having charge of its books of account, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation, nor shall he be so liable if in good faith in determining the amount available for any such dividend or distribution he considered the assets to be of their book value."

The adopting states are as follows, with those not having the last sentence on book value being marked with an asterisk (*):

Alabama*	Ohio
Alaska	Oklahoma*
California*	Oregon
Colorado	Pennsylvania*
Connecticut ¹	South Dakota
Illinois	Texas
Iowa	Utah
Kentucky	Virginia ³
Maryland*	Wisconsin
Minnesota*	Wyoming
North Carolina ²	District of Columbia
North Dakota	

"Book value," it bears emphasizing, may be anyone's book value, not only that which is in accord with generally accepted accounting principles. Nonetheless, in these 23 states there is a suggestion that, given certain kinds of

1. Connecticut, the only state of the 52 to provide that all statements on which directors may rely are to be prepared in accord with generally accepted accounting principles, would impliedly permit reliance on book values.
2. North Carolina, through repeated references in other corporation-law sections to its home-grown and undefined phrase, "generally accepted principles of sound accounting practice," would seem to look favorably on a directors' reliance on book values.
3. Instead of "book value," Virginia uses "cost."

data on which directors might rely, appreciation surplus may not be a valid source for dividends. But there would be no assurance in these 23 states that directors are necessarily relying on a source (i.e., certified financial statements)⁴⁴ that would lead to its exclusion.

Like other demonstrated equivocations in present dividend laws, there is no excuse for the lack of a clear enunciation of a state's position on appreciation surplus. Regrettably, the Model Act does not take a stand on the matter. In this respect, it is less desirable a model than was the Uniform Act, which did.

Revaluation of Assets by Directors. The argument is sometimes advanced that directors should be allowed to revalue assets for dividend purposes. It is often pointed out that accountants' book values do not in most instances purport to be representative of current market values. Directors, it is contended, must base their decisions on current realities, not on history. Hence, the syllogistic logic follows, directors must go beyond the books in deciding on proposed actions, such as dividend declarations.

Two closely related arguments against the use of surplus arising from unrealized appreciation of fixed assets are more telling. First, if the market value has risen, no additional cash or other distributable properties are *ipso facto* available for dividend payments, except where there have been borrowings against such fixed assets. Such distributable properties may be acquired by sales of products and services and by *realized* gains on asset exchanges. The second argument was ably set forth by Mr. Justice Pitney in 1941:

"There is a logical incongruity in entering upon the books of a corporation as the capital value of

property acquired for permanent employment in its business and still retained for that purpose, a sum corresponding not to its cost but to what probably might be realized by sale in the market. It is not merely that the market value has not been realized or tested by sale made, but that sale cannot be made without abandoning the very purpose for which the property is held. . . ."⁴⁵

It would not be objectionable, as may be inferred from the above, for the directors to make adjustments for changes in the value of marketable securities and readily-salable merchandise.

Appreciation surplus, as this term (or its equivalent) is used by legislators and the courts, presumably refers to changes both in the prices of individual assets (i.e., purely structural price changes) as well as in the general price level. But these two phenomena are conceptually different from each other and should be kept apart. For dividend purposes—as well as for many other purposes—conventional financial statements should be revised to include explicit recognition of changes in the general price level, for such changes act to weaken the validity of a major assumption upon which financial statements are currently founded, viz., that the monetary unit is stable. Admittedly, many practical questions as to the method of effecting such a revision remain unanswered, but some attempt should be made to separate price-structure from price-level fluctuations.⁴⁶ (The term "appreciation surplus," as used in the above paragraphs wherein it is argued that it should not be a source of dividends, is accordingly to be understood as including only price-structure changes.)

TAX STATUS OF DIVIDENDS

Federal Income Tax. The taxability for federal income tax purposes of cor-

porate distributions paid in cash or other property is not dependent on the source that directors have chosen to distribute. Hence, although prerequisites for a dividend are set down by state corporation law, the taxability of corporate distributions (whether or not state law would classify them as dividends) is separately determined by the Internal Revenue Code. As one writer says:

"The term 'dividend' as defined for income tax purposes by Sec. 316(a) [of the 1954 Code] does not correspond to the term 'dividend' under state law, with the result that a corporate distribution may be a 'dividend' under Sec. 316(a), although it impairs capital or is otherwise unlawful under state law. Conversely, it is possible for a distribution to constitute a lawful 'dividend' under state law without qualifying as a 'dividend' under Sec. 316(a)."⁴⁷

Section 316(a) of the Code sets the ground rules for determining which corporate distributions are "dividends" for most income tax purposes.⁴⁸ Distributions are taxable to the extent that their amount (adjusted basis in the case of distributions paid in kind) does not exceed: *first*, the "earnings and profits" of the taxable year in which the distribution is effected, but, if this source is exhausted by such distribution(s), the balance of the distribution is taxable to the extent that its amount does not exceed: *second*, the "earnings and profits" accumulated since February 28, 1913. It is important to note that, like the laws of the current-net-earnings states, the federal income tax law declares that a distribution is taxable if there are current "earnings and profits" to cover it—irrespective of the presence of a capital impairment. Consequently, directors cannot control the tax status of dividends by picking and choosing from

among several different sources. Whether a distribution is taxable depends on the status of certain financial facts. Furthermore, the "earnings and profits" must be computed as of the close of the taxable year for purposes of distributions made during that year.

Nowhere in the Code is the phrase "earnings and profits" comprehensively defined. Its meaning must be inferred from a few statutory references thereto, some fairly broad statements in the regulations, and relevant court decisions.⁴⁹

THE QUESTION OF NOTICE

The following excerpt is taken from the report of the bar associations of the City and State of New York on the then pending bill to overhaul that state's corporation law:

"... we believe that the disclosure requirement is not of sufficient importance to justify this change [i.e., the requirement of notice to be made when the source of a dividend is not earned surplus] from the existing corporation laws [under "existing laws," no such notice is demanded]. Publicly held corporations are already adequately regulated by stock exchanges and S.E.C. rules, and the supposed advantages of the disclosure requirement are largely inapplicable to small and closely held corporations. The directors and officers of small corporations will probably in many cases fail to comply with the requirement simply by reason of unfamiliarity with it and will thereby be trapped into unintended violations. . . .

"Even if the underlying principle as to the distinction between earned surplus and capital surplus were acceptable, compliance with the disclosure requirement will often be impossible. . . . Not infrequently a corporation would be uncertain of

the source of a distribution until after the close of the fiscal year and then only after its accountants had completed their audit.”⁵⁰

The two-committee report (as it will hereinafter be called) looks disparagingly on the important economic distinction between income and capital, i.e., between earned surplus and the sum of state capital and capital surplus. However, the issuance price of shares, in order to minimize franchise taxes as well as for other reasons, may be far in excess of “par”—a quantum that becomes more and more nominal as capital surplus expands relative to it. The only important distinction for a going concern is the one between stockholders’ original (and subsequent) contributions and accretions thereto due to successful operations. A notable difference exists between returning to a party his original investment and dividing funds subsequently accumulated in the course of pursuing the business purpose. And the line of demarcation between stated capital and surplus, important in times of distress, should not be permitted to obscure the dominant distinction applicable to a going concern.

Directors’ Risks. It may be true, as the committees contend, that directors in good faith may not know with certainty at the time of, say, a quarterly (or even year-end) distribution whether its source is earned surplus or otherwise. New York (eff. 4/1/63) appears to have a feasible solution: if the source is not then determinable with certainty, communicate this fact to stockholders at the time of distribution—indicating also the . . . “approximate effect of such dividend or distribution upon stated capital, capital surplus and earned surplus. . . .”⁵¹ But this circumstance, which will not arise very often, should not gainsay the use of notice altogether.

Directors of small corporations, the two-committee report asserts, will be “trapped into unintended violations.” In reply, one may query whether the stockholders and creditors of small corporations are any less deserving of protection than are those of the giants. To be sure, the usual secrecy surrounding the operations of small firms may place stockholders and creditors (potential or actual) in more vulnerable positions, warranting *at least* the same disclosures of the true character of overt corporate actions as are required of larger corporations.

SEC and Stock Exchange Requirements. Finally, one may question the two committees’ impression that the regulations of the national exchanges and Securities and Exchange Commission (hereinafter referred to as the “Commission”) adequately fulfill the need for notice of a dividend source, if it is not earned surplus. Other than as a result of the excellent requirements of the New York Stock Exchange, unregulated corporations have no obligation (besides that imposed by state corporation law) to notify stockholders or the public generally of atypical sources of dividends. The results of such actions will, for many corporations (both listed and unlisted), be reflected in financial statements filed with the Commission, but the latter agency has no control over financial reports that corporations send to stockholders—save in the case of regulated investment companies and, to a lesser extent, of registered public utility holding companies.

The New York Stock Exchange has for many years included the following paragraph in its listing agreement:

“The Corporation will not make, nor will it permit any subsidiary directly or indirectly controlled by it to make, any substantial charges

against capital surplus, without notifying the Exchange. If so requested by the Exchange, the Corporation will submit such charges of stockholders for approval or ratification."

Under normal circumstances, the Exchange would request that stockholder approval be obtained prior to such distributions.

On occasions when corporations listed on the New York Stock Exchange have paid dividends from stated capital, the Exchange has looked for an accompanying explanatory letter to stockholders. Furthermore, the Exchange's *Weekly Bulletin* customarily calls the attention of the financial community to such actions.

The American Stock Exchange has no written formal policy for dividends paid from other than earned surplus. It would expect only that the accounting treatment be in accordance with generally accepted accounting principles and in conformity with the relevant laws.

The Commission, in administering the Public Utility Holding Company Act of 1935, has generally restricted the source of dividends to earned surplus. Its Rule 46, effectuating the fairly broad Section 12(c) of the Act, recites:

"No registered holding company or subsidiary thereof shall declare or pay any dividends on any security of such company out of capital or unearned surplus, except pursuant to a declaration notifying the Commission of the proposed transaction, which has become effective in accordance with the procedure specified in rule 23, and pursuant to the order of the Commission with respect to such declaration under the applicable provisions of the Act."

In 1940, the Commission said:

"The showing of an earned surplus credit after the payment of dividends

gives a false picture of corporate strength where the earned surplus credit remains only because the dividends have been charged to capital surplus. Dividends should, in our opinion, be charged to earned surplus where such a surplus exists."⁵²

In nine instances from 1938 to 1941, the Commission permitted two holding companies, both incorporated in Delaware, to pay dividends on senior preferred shares in the absence of an earned surplus.⁵³ Several conditions had to be met, however: cash funds are to be sufficient, the dividend should not impair the financial integrity of any companies in the holding company system, the rights of senior securities are not to be thereby infringed, and the next subsequent earnings must be used to repair any deficit in capital surplus caused by the dividend payment. In these cases, the Commission preferred that the dividends be covered by current earnings, even if an earned surplus deficit existed. But these nine instances were exceptions, occasioned by temporarily embarrassing circumstances.

Section 19 of the Investment Company Act of 1940 allows the Commission even less discretion. Dividends, according to that section, may be paid only out of "accumulated undistributed net income" or out of "net income . . . for the current or preceding fiscal year" "unless such payment is accompanied by a written statement which adequately discloses the source of [the distribution]."⁵⁴ The flavor of the current-net-earnings test is evident.

Consequently, with the exception of registered public utility holding companies, regulated investment companies, and corporations listed on the New York Stock Exchange, no adequate notification requirement (aside from that called for by state law) for

dividends declared out of other than earned surplus is imposed on corporations. Stockholders and other parties must infer (if they can) the true source from financial reports sent to stockholders or filed with the Commission—and only a minority of corporations are subject to both of these responsibilities.

Many corporations, although they may not be required to furnish stockholders directly with financial information, must file a financial report with the Commission. Data contained therein may be obtained only by application made to that agency.

It is evident that the two-committee report dismisses altogether too lightly the importance of a notification requirement in state dividend provisions. Indeed, even if other bodies were presently requiring adequate notice of dividend sources, the principle of full and fair disclosure with respect to corporate distributions should receive statutory expression in every state.

MISCELLANIES

The American Institute of Certified Public Accountants has recommended the discontinuance of the term "surplus" in connection with the presentation of the stockholders' equity section of the balance sheet. See *Review and Resume: Accounting Terminology Bulletin No. 1.* (1953), p. 30. However, since corporation statutes still employ the older accounting terminology, "surplus" is also used herein.

Except where otherwise indicated,

all statutes herein mentioned are in effect as of January 1, 1962.

WHAT ACCOUNTANTS CAN DO

Accountants should be concerned when directors are given authority to withhold disclosure of the nature of abnormal corporate distributions, thereby allowing the presumption that they were dividends in the usual course. Adequate information safeguards should be provided, and accountants—whose principle activities surround financial communication—have a duty to work with legislators to assure that the minimum standards of corporate disclosure protect third parties from misleading inferences. A double standard of corporate reporting—one for audited financial statements and another for other disclosures—is self-defeating.

It would also seem desirable to narrow the range of differences in dividend criteria among the states. At the least, less ambiguity in dividend provisions is needed. Legislators should be urged to eliminate equivocal language, else directors may unintentionally cause the initiation of numerous lawsuits.

Finally, legislators should be encouraged to adopt the conventional accounting meanings of accounting terms which they use, in order that financial statements could more effectively serve as vehicles for disclosure of the true character of corporate transactions.

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TABLE C

STATES THAT USE DIVIDEND
LANGUAGE OF MODEL ACT:
NOTES AS TO CERTAIN DEVIATIONS
THEREFROM

Alabama
(no definition of insolvency)
Alaska
Connecticut—includes both definitions of
insolvency
North Dakota
Oregon
(uses "unreserved earned surplus" instead
of "unreserved and unrestricted earned
surplus")
Pennsylvania
(makes assets-preference clause applicable
to all dividends; earned surplus does not
include appreciation surplus)
Texas
Utah
Virginia
(in place of Model Act Section 41, Virginia
statute allows capital surplus as a
source generally, but only with Notice)
Wisconsin

B. SOURCE: surplus.

LIMITATIONS: as indicated.

Illinois

(limitations: paid-in surplus, including
reduction surplus and treasury stock
surplus, is available only for shares
having dividend preferences, but only
with Notice; equity insolvency; ap-
preciation surplus is not a proper
source)

Louisiana

(limitations: Notice, if paid-in sur-
plus is the source; certain kinds of un-
realized and unearned gains are not
proper sources)

Maryland

(limitations: bankruptcy and equity
insolvency; Notice, if other than
earned surplus is the source)

Missouri

(limitations: paid-in surplus is a prop-
er source only if (1) Notice is given;
(2) all cumulative and other divi-
dend rights of preferred shares have
been satisfied; and (3) existing and re-
sulting capital impairment are absent)

New York (eff. 4/1/63)

(limitations: equity insolvency; No-
tice, if other than earned surplus is
the source; earned surplus does not
include appreciation surplus)

Ohio

(limitations: equity insolvency; No-
tice, if capital surplus is the source;
appreciation surplus is not a proper
source)

District of Columbia

(limitations: equity insolvency; paid-in
surplus and treasury stock surplus are
available only for shares having divi-
dend preferences, but only with No-
tice).

C. Hawaii:

"profits and earned surplus" (limitation:
existing and resulting capital impairment
must be absent)

NOTE:

"Notice," as used above, requires dis-
closure of the source, except in Missouri,
where the notice need state that the dis-
tribution is a "liquidating dividend."
"Insolvency," as used above, implies both
existing and resulting insolvency.

CONTINUED ON NEXT PAGE

TABLE E

A SUMMARY OF THE SIGNIFICANT
ELEMENTS OF THE DIVIDEND
PROVISIONS OF
CAPITAL- IMPAIRMENT STATES:
ORDINARY DIVIDENDS

A. SOURCE: surplus
B. LIMITATIONS: as indicated.

Arizona

Idaho

(limitations: certain unrealized and unearned gains are not proper sources)

Iowa

(limitations: equity insolvency; appreciation surplus is not a proper source)

Kentucky

(limitation: undefined insolvency)

Maine

Mississippi

(limitation: undefined insolvency)

New York (current)

South Dakota

Vermont

Washington

(limitations: certain unrealized and unearned gains are not proper sources)

Colorado:

Sources:

- (1) unreserved and unrestricted earned surplus
- (2) excess of net assets over stated capital.

Limitations:

- (1) equity insolvency
- (2) assets-preference clause applicable to source (2), and, presumably, to source (1).

NOTE: "Insolvency," as used above, implies both existing and resulting insolvency.

REFERENCES

27. A two-thirds stockholder approval is required in Texas for distributions from reduction surplus. In Connecticut, corporations having only one class of stock need not look to either a charter provision or stockholder vote, if capital surplus is to be distributed.

28. Texas requires disclosure of the source where reduction surplus is used.

29. See Hackney, *op. cit.*, pp. 1387-88.

30. Prior to adoption in 1951 by Wisconsin of the Model Act definition of earned surplus, no corporation statute had defined the term. The Model Act definition is based on that contained in Accounting Research Bulletin No. 9 (special; issued in 1941), p. 75—essentially the same definition as that which appears in *Review and Resume, Accounting Terminology Bulletin No. 1* (issued in 1953), p. 16.

31. As noted above, New Jersey (and possibly New Mexico)—by court interpretation—is apparently an earned-surplus state.

32. The effectiveness of "equity insolvency" as a deterrent in cases in which the directors would otherwise wish to pay dividends is questionable. For if the firm is on the verge of being unable to pay creditors, it is also likely that it has not sufficient cash for a dividend payment. For proposed non-cash dividend payments, "equity insolvency" would have greater significance as a limitation.

33. It is clear that this clause limits all ordinary dividends in Pennsylvania; in Colorado, such appears to be a fair inference from Subsection (d) of Section 42, Colorado Corporation Act [of 1958].

34. Robert H. Montgomery, *Auditing Theory and Practice* (5th ed.; New York: The Ronald Press Company, 1934), pp. 411, 443.

35. William A. Paton, *Advanced Accounting* (New York: The Macmillan Company, 1941), pp. 524, 567.

36. Editorial [written by Eric L. Kohler], 9 *The Accounting Review* 254 (September, 1934).
37. H. A. Finney and Herbert E. Miller, *Principles of Accounting—Intermediate* (5th ed.; Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1958), p. 138.
38. N. H. Rev. Stat. Ann. Sec. 294-101.
39. "Dividend law is not the place to set up regulations regarding insolvency or financial reorganization." A. C. Littleton, "The Dividend Base," 9 *The Accounting Review* 140, 145 (June, 1934).
40. N.Y.S. 2d 173 (Sup. Ct. 1940), *aff'd*, 262 App. Div. 844, 29 N.Y.S. 2d 512 (1st Dept. 1941), *aff'd*, 288 N.Y. 280, 43 N.E. 2d 43 (1942).
41. 63 A.2d 577 (Del. Ch. 1949).
42. 63 A.2d at 582. The court was careful to point out that no formal appraisal is necessary.
43. See, for example, 34 *Nebraska Law Review* 531, 536 (March, 1955); 4 *Arkansas Law Review* 208, esp. 209-10 and notes 2, 3, and 4 (Spring, 1950); Meek, *op. cit.*, p. 7; and "Unrealized Appreciation on Corporate Dividends," 2 *Drake Law Review* 14 (November, 1952), relating to the older of the two presently-used Iowa corporation laws. "Although there are no cases in Colorado concerning appreciation surplus, such surplus may be available as a source for dividends." 31 *Rocky Mountain Law Review* 49, 60 (December, 1958). Also see Kriedmann, *op. cit.*, pp. 379-81; and Hills, *op. cit.*, pp. 87-88, 154-55.
44. A certificate would be qualified if a material write-up, not in accord with generally accepted accounting principles, is reflected in the balance sheet. Financial statements with such a qualification may nonetheless be a valid basis for directors' reliance in these 23 states.
45. *LaBelle Iron Works v. United States*, 256 U.S. 377, 393.
46. See Ralph Coughenour Jones, *Effects of Price Level Changes on Business Income, Capital, and Taxes* ([n.p.] American Accounting Association, 1956); and Ralph Coughenour Jones, *Price Level Changes and Financial Statements: Case Studies of Four Companies* ([n.p.] American Accounting Association, 1955).
47. Boris I. Bittker, "Corporate Dividends and Other Nonliquidating Distributions in Cash, Property, Stock, and Obligations," 5 *Howard Law Journal* 46, 52-53.
48. The regulations for Sec. 316 are particularly helpful. See 26 CFR Part I Secs. 1.316-1, 1.316-2 (unchanged since December 3, 1955).
49. For a discussion of the apparent meaning of "earnings and profits," together with citations to further source material, see Bittker, *op. cit.*, pp. 55-64.
50. Joint Report of the New York State Bar Association, Committee on Corporation Law, and the Association of the Bar of The City of New York, Committee on Corporate Law, on Proposed New York Business Corporation Law, 1961 Senate Int. 522, Assembly Int. 885, pp. 13-14. The bar associations offered a substitute draft which was substantially the one passed by the legislature and signed into law.
51. (January, 1959). Also see William D. Andrews, "Out of Earnings and Profits: Some Reflections on the Taxation of Dividends," 69 *Harvard Law Review* 1403 (June, 1956). Note especially Andrews' recommendations on pp. 1436, 1438-39.
52. *In the Matter of Associated Gas and Electric Corporation*, 6 S.E.C. 605, 619.
53. *In the Matter of Columbia Gas & Electric Corporation*, 3 S.E.C. 313 (1938), 3 S.E.C. 562 (1938), and 3 S.E.C. 986 (1938). *In the Matter of International Utilities Corporation*, 5 S.E.C. 403 (1939), 6 S.E.C. 29 (1939), 6 S.E.C. 746 (1940) (but see 6 S.E.C. 801 (1940) where the holding company's request was denied), 7 S.E.C. 201 (1940), 7 S.E.C. 872 (1940), and 8 S.E.C. 494 (1941).

THE END

Splitting A Single Business Tax-Free—The Coady Decision

By IRA J. PALESTIN

Part of a single active corporate business may be split off to stockholders without recognition of gain or loss, under Section 355 of the Internal Revenue Code. The provision in the Regulations prohibiting tax-free division of a single business is unsupported by the Code and invalid. So held a unanimous Court of Appeals, 6th Circuit, by order issued April 28, 1961 affirming the majority opinion of a widely-divided Tax Court. *Comm. v. Coady*, 289 F. (2d) 490; 33 T.C. 771.

FACTS IN THE CASE

Involved was a division of assets of a close corporation between two equal, disputing stockholders who finally agreed to separate. Approximately half their corporation's assets were transferred to a newly organized corporation in return for its original stock issue. Such stock was then transferred by the original corporation to one of the disputing principals, in exchange for his stock in the original corporation. In this manner each of the stockholders became owners of all the

issued stock of two separate corporations—each corporation owning approximately 50% of the assets of the single original business. Two active corporate businesses thus appeared in place of the original enterprise. No gain or loss was recognized in the transaction.

APPLICABLE CODE SECTION

Section 355 contains the provisions of the Internal Revenue Code relating to division of a corporation's business into separate entities without recognition of gain or loss to recipient shareholders. By corporate separation or division is meant the transference of part of a corporate enterprise to a separate corporation or corporations whose stock is issued to the original (dividing) corporation; such subsidiary's stock is then distributed to the parent corporation's stockholders as a unilateral spin-off, or it is exchanged in a split-off for a surrender of part of the parent's stock, or it forms part of the mechanics of a split-up. In the split-up the parent's assets are totally divided between two or more new corporations in return for their stock issue; the parent then liquidates and distributes such stock to its own shareholders in dissolution..

IRA J. PALESTIN, a member of the New York Bar, is a Commissioner of the New York State Tax Commission. He was first appointed to this post by Gov. Harriman and was recently reappointed for another term by Gov. Rockefeller.

There is no disappearance of the business activity in these cases. Instead, there is ". . . a continuity of the entire business enterprise under modified forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange."¹

Captioned "DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION," Section 355 plus involves the separate ownership at the shareholder level of the same corporate business existing before the division.² 355(b) provides that both distributing and controlled corporations must actively conduct a trade or business immediately after the distribution. Included in the statutory definition of trade or business activity is the requirement that such trade or business shall have continued for a five-year period preceding the distribution. This latter condition was characterized by the Senate Finance Committee, upon enactment of the 1954 Code, as "a safeguard against avoidance not contained in extsting law."³

Congress was concerned with preventing changes in ownership form as a usable device to bail out untaxed earnings and profits, or assets acquired therefrom. What could be separated off without recognition of gain or loss were two or more separate businesses formerly operated by a single corporation and actively conducted for at least five years. See Reg. Sec. 1.355-1(a). It was felt that a corporation would be unwilling to lose an established operation built out of earnings just to make tax-free distributions to its shareholders. The requirement of a historical five-year activity could sieve out tax-free liquidations of businesses created out of earnings and profits.

Since the whole is equal to the sum of its parts, it would seem that active

businesses existing *after* the split and distribution could together have constituted but one entire business before division took place. The splitting of a vertically integrated business tax-free—e.g., separating-off a coal mine owned and operated by a steel manufacturing plant in its steel production—should be possible. But no, said the Treasury's Regulations, a single business can't be divided under Section 355.⁴

COURT DECISION

Answering this, the majority opinion in the Tax Court stated that the definition in section 355 (b)(2) does not require conduct of two or more whole businesses by the original corporation. The statute refers to plural corporate entities, not plural whole businesses. The requirement for active business by each corporation after the separation is intended to prevent a tax-free sloughing-off of inactive assets—i.e. it can block tax-free distribution of dividend equivalents.⁵ A single business can be divided under Section 355.⁶

NEW YORK STATE TAX STATUS

About New York State Law: In

1. The quotation is from Reg. Sec. 1.355-2(c).

For non-recognition of gain or loss to a corporation participating in a divisive reorganization see Secs. 361 and 368(a) (1) (D).

3. S. Rept. 1622, 83rd Cong. 2nd Sess. (1954) p. 51.

4. Reg. Secs. 1.355-1(a), 1.355-1(d) Example (12). However, the Treasury was quick to accord business plurality to the operation of branches of the same enterprise in different states; and it distinguished rather sharply between a furniture business and an appliance business in approving a split-off of the two, effecting a separation between two disputing stockholders each of whom ended up as the sole owner of his own enterprise in a tax-free reorganization. See Rev. Rul. 56-344, 1956-2 CB 195; and Rev. Rul. 56-655, 1956-2 CB 214.

1960, Article 22 of the State Tax Law was enacted. That substantially conformed the state income tax law to the federal. Before its effective date, New York accorded no tax deferment to spin-offs, although it followed federal law on split-offs and split-ups. Now, of course, under the conformed state income tax law our state will follow the federal treatment of spin-offs as well.

CONSEQUENCES OF DECISION

The business world will hail the *Coady* decision. Where there are sufficient business reasons for splitting a going corporate enterprise, mere alteration in its form should not be the occasion of taxation.

Will other federal courts follow *Coady*? If a single business can be split under Sections 355 and 368, what becomes of Example (11) contained in Regulations Section 1.355-1(d)? That states that manufacturing and selling operations are parts of but one integrated business: spinning-off the sales end should produce usual tax consequences instead of tax deferment. Does *Coady* mean that Example (11) and cognate portions of the federal Regulations are to be scrapped?

What the federal treatment will definitively prove to be remains to be

seen. As recently as October 3, 1961 the I.R.S. announced its non-acquiescence in the Court of Appeals *Coady* affirmation. Involved is the ever-present problem of framing a rule to distinguish feasibly between legitimate business development that should be free of tax, and untaxed distributions of corporate earnings and profits. Resolution of this problem has never been easy—in or out of Congress. The future of *Coady* bears watching.

5. An example of this would be the organizing of a new corporation to hold securities acquired by the parent or to hold and rent valuable machinery no longer used in its business—the parent receiving the new corporation's stock in exchange for these assets and spinning-off this stock to its own shareholders. See Reg. Sec. 1.355-1(c).

6. But under Rev. Rul. 59-400, 1959-2 CB 114, it is doubtful if business assets or a business department acquired and paid for out of earnings of the parent's surviving enterprise could be spun-off to its shareholders without gain or loss recognition. Furthermore, the Tax Court in *Theodore F. Appleby*, 35 T.C. —, No. 86, decided a year after *Coady*, held that, although a single business actively conducted for the requisite five years can be split, there can be no tax-free separation of rental property that was merely incidental to the main going business and by itself was not actively conducted for the five-year period.

THE VALUE OF IMMEDIATE REWARDS

The first generalization we can make is that organisms (pigeons, certainly, and people, probably) like to receive immediate rewards for work accomplishment. If this, upon further experiment, turns out to be the best way of motivating human workers, would this not outweigh the conveniences of bookkeeping that are inherent in the regular salary schedules now increasingly in vogue in business?

Thus, one pointed suggestion for improving prevailing wage systems would be to conduct experiments with plans that reward the individual immediately upon completion of his task. Experiments have also indicated that even a small delay in rewarding destroys a certain amount of working incentive.

OWEN ALDIS, "Of Pigeons and Men," HARVARD BUSINESS REVIEW, July-August 1961

Elementary Tax Concepts of Combining and Reorganizing Corporations

By HERBERT M. PAUL, M.B.A., LL.M.

Today's business climate is characterized by the large number of mergers, consolidations and purchases of going concerns. Such combinations are prevalent among both large and small corporations. Accordingly, the attendant tax problems are of concern to virtually all accountants.

The tax aspects of a proposed combination sometimes "make or break it" and are always a vital consideration. Some otherwise worthy transactions are destroyed by costly tax consequences or by even the fear of costly tax consequences. On the other hand, some seemingly unattractive transactions are made attractive by adroit tax planning.

Tax problems of combining businesses are considered by many practitioners to involve the most difficult aspects of taxation. Obviously, therefore, their treatment in an article can hardly be exhaustive. Moreover, this article is intended to acquaint the accountant who deals with the subject only occasionally with the broad general tax principles and the basic elements of recognized combining techniques.

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TAXABLE COMBINATIONS

A taxable combination results from the *purchase* of a business entity. For tax purposes, this form of combining is considered as a completed and closed transaction. Thus, except in the case of a qualifying installment sale, the entire gain on the sale is considered as earned in the year of the transaction. The tax basis of the property acquired, for depreciation purposes and for determining subsequent gain or loss by the buyer, is the purchase price except in transactions between related entities.

TAX-FREE COMBINATIONS

Frequently, the value of a company about to be combined with another has grown so large that tax on the gain involved in a taxable combination would be undesirable. Accordingly, the usual form of combining business entities involves a tax-free combination or what is commonly called a tax-free reorganization. Actually, the term "tax-free" is a misnomer; what is really meant is a tax deferral or postponement. That is, the recognition of income is postponed until the property which is received in the exchange is finally disposed of in a closed and completed taxable transaction.

Tax-free treatment has been provided because of the feeling that certain situations, which qualify as

tax-free reorganizations, do not involve a completed or closed transaction. There has merely been a change in the legal form of the corporations representing the investment, without any real change in the business holdings. The participants in the reorganizations do not wind up with anything more or less than they had before, although the form of their investment has changed. They retain a continuing economic interest in a new and enlarged economic enterprise.

The Internal Revenue Code* provides that no gain or loss shall result from specified transactions which qualify as reorganizations under the Code's definition of that term. In particular, no gain or loss is recognized to a shareholder, if stock or securities in a corporation which is a party to a reorganization are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation which is a party to the reorganization. Similarly, no gain or loss is recognized to a corporation, which is a party to a reorganization, if it exchanges property, in pursuance of a plan of reorganization, solely, for stock or securities in another corporation which is a party to a reorganization.

As can be seen, the key element of these tax-free transactions is that there be a combining of two corporate enterprises which qualifies as a reorganization. The Internal Revenue Code, Section 368(a), specifically describes the various transactions which will be treated as reorganizations for tax purposes. There are three specific procedures which are generally used for combining businesses. These procedures are listed in Sub-Sections (a)(1)(A), (B), and (C), and are therefore referred to as the "A," "B"

and "C" reorganizations. It should be noted that the requirements of the Code must be strictly adhered to before the tax-free treatment will be allowed. First, there must be an exchange pursuant to a plan of reorganization. Second, the special treatment will be accorded only to those corporations which qualify as a party to the reorganization or to shareholders who exchange stock of corporations which so qualify. Third, the transaction must be one of those described by the Code. In addition to the requirements specified in the Code, there have grown up, as a result of many court decisions, additional requirements which also must be met.

The "A" Reorganization. The simplest type of reorganization is an "A" reorganization. It is a statutory merger or consolidation. A merger is the combining of one corporation into another corporation under the statutes of a particular state or country with the resulting survival of one of the participants; this survivor being the sum of the two participants. In contrast to this, a consolidation is the combining of two existing corporations into a newly formed third corporation. As in a merger, the newly formed corporation is the sum of the two participants.

Although the "A" reorganization is the simplest form from a standpoint of Code requirements, it is not the most commonly used. This is because in dealing with a statutory merger or consolidation, the transaction must be accomplished according to state law, and there are often many practical problems of complying with the legal requirements of the state or states of incorporation of the participants. Also, the right of dissenting stockholders to demand the payment of the fair market value of their stock can be an important factor.

* Section 354 (applicable to shareholders) and Section 361 (applicable to the reorganized corporations).

The "B" Reorganization. A "B" reorganization contemplates the acquisition by one corporation of control of another corporation solely in exchange for voting stock of such acquiring corporation. This can be described as a stock-for-stock exchange.

There are requirements both as to the stock being acquired and the consideration given for it. The stock being acquired must give the acquiring corporation "control" of the acquired corporation. The term "control," when used in the reorganization sections refers to the ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the acquired corporation. This requirement of 80 percent is higher than the percentage required to consolidate for accounting purposes. The S.E.C. for example, only requires "more than 50 percent" control in order to consolidate for financial reporting purposes.

Regulations provide that the total stock owned which makes up the controlling interest need not be acquired in one transaction. A "creeping type" of acquisition is permitted wherein control of a corporation can be obtained over a period of time. The 80 percent requirement need only be met in regard to the particular acquisition for which tax-free treatment is desired.

In addition, it should be realized that the transaction will be granted the special treatment only if the block of stock which secures the required control is obtained solely for voting stock of the acquiring corporation. No other consideration is permitted. However, there is no minimum amount of voting stock of the acquiring corporation which must be given up. A "creeping type" of acquisition permits the

prior acquisitions of stock of the acquired corporation for any property, say, cash. Such a prior acquisition for cash is permitted as long as the non-qualifying transaction was independent of the qualifying transaction. If the immediate and previous acquisitions are found to be part of a general plan, then all the transactions will be considered together. If the acquisitions are linked together, then the requirement of acquiring control solely for voting stock of the acquiring corporation will not be met and the transaction will be taxable.

The "C" Reorganization. The third type of reorganization used to combine businesses, a "C" reorganization, is a stock-for-assets exchange. Here, there is an acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all the properties of another corporation. Normally such a reorganization is followed by the liquidation of the transferor corporation and the distribution, tax-free, of the stock of the transferee corporation. The assumption by the acquiring corporation of liabilities of the other corporation is not treated as other consideration given which would bar treatment as a tax-free reorganization. It should be noted that although the "C" reorganization and a merger give the same results the "C" reorganization route is the one commonly used.

The statutory definition of a "C" reorganization specifies that "substantially all" of the properties have to be acquired, but nowhere is there found a definition of the term "substantially all." The Treasury Department has taken the position that "substantially all" the properties of a corporation are acquired if 90 percent or more of the net assets of the particular corporation are acquired. It is understood that when we talk of

property we are referring to the value of the respective properties and not their cost, size, weight or any other method which might be used for describing such properties. The retention of a reasonable amount of assets necessary to meet the obligations of the acquired corporation shall be disregarded in determining if the "substantially all" test is met. However, if assets are retained to pay liabilities and these assets turn out to be in excess of the liabilities, the distribution of such assets will probably be taxed as a dividend.

There is a variation of the above-described third type of exchange which is permitted by the Code. This variation provides that the voting stock to be given up can be that of a corporation which is in control of the acquiring corporation. Such a corporation is commonly referred to as a parent corporation. Thus, the "C" reorganization adopts a consolidation approach, of realizing that a parent corporation and its subsidiary should, in certain instances, be viewed as one. A subsidiary corporation can therefore receive properties which are the subject of a reorganization transaction in spite of the fact that the consideration for such properties is paid by its parent corporation, which is a separate legal entity.

In examining the variations just referred to, there is one point which must be carefully observed. Although the stock given up may be that of the corporation or its parent there cannot be any mixing. The stock given up must be that of the corporation *or* its parent and not the stock of the corporation *and* its parent. However, the property to be received in exchange for the stock can go to either the corporation or its subsidiary or subsidiaries, or part to the corporation and part to its subsidiary or subsidiaries.

There is an exception to the "solely

for voting stock" requirement of the "C" reorganization. However, it is not often used because usually it will not be advantageous to do so. Thus, the Code provides that other consideration may be given in addition to voting stock and the assumption of liabilities where substantially all the assets of another corporation are being acquired. But in such case, the value of the stock given in consideration must equal at least 80 percent of the total gross assets of the other corporation. This means that the sum of the liabilities assumed and the consideration other than voting stock cannot exceed 20% of the total consideration given.

The above-mentioned three types of reorganizations are the ones primarily used to combine business entities. However, there are three other types of reorganization prescribed by the Code, Section 368(a)(1)(D), (E), and (F). These latter three are used either to divide an existing corporation or to merely modify the capital structure of an existing corporation.

DIVISIVE REORGANIZATIONS

The fourth type of situation which the Code defines as a tax-free reorganization is a transfer by a corporation of all or part of its assets to another corporation, if immediately after the transfer, the transferor or one or more of its stockholders, or any combination thereof, are in control of the corporation to which the assets are transferred. This reorganization is generally used as a preliminary step in a corporate separation. Thus, it is a method of splitting off a segment of the property of a corporation to a subsidiary corporation, the stock of which will, in turn, be distributed to shareholders of the parent corporation. Reorganizations under this sub-section are generally referred to as "split-ups," "split-offs," and "spin-offs."

RECAPITALIZATION

The fifth transaction which the Code defines as a tax-free reorganization is a recapitalization. Neither the Code nor the Regulations define the term "recapitalization." Case law, however, has stated that a recapitalization takes place where there is a reshuffling of the capital structure of a corporation. This reshuffling may be either of the debt structure or of the equity interests, or both, of the corporation. The primary reasons for recapitalizations are non-tax considerations. Some of these reasons are as follows:

- (1) Improvement of corporate credit picture by replacing debt financing with equity financing.
- (2) A more flexible capital structure which would, say, provide more attractive stock for corporate employees.

Recapitalizations involving the issuance of debt in exchange for stock resulting in the increase or creation of debt do not qualify as tax-free reorganizations.

CHANGE IN IDENTITY, FORM, ETC.

A mere change in the identity, form or place of organization, no matter how effected, is classified as the sixth type of tax-free reorganization. This would include changing the corporate name or incorporating in a different state.

PARTIALLY TAX-FREE COMBINATIONS

If, in the reorganization, a taxpayer obtains a greater principal amount of securities than he had before the reorganization, then the reorganization is not completely tax-free. The term "securities" refers only to debt and not to stock. Thus a reorganization cannot be used to establish or increase debt due to shareholders and thereby conceal a distribution of profits, which should be treated as a dividend.

BASIS

If property or stock or securities is

acquired by a corporation, in a tax-free reorganization, as a result of the issuance of its stock or securities then the basis of the property or stock or securities so received is the same as it would be in the hands of the transferor. The basis to a taxpayer who receives stock or securities in a tax-free reorganization as a result of exchanging property, is the same as that of the property exchanged.

SOME ADDITIONAL REQUIREMENTS AND CONSIDERATIONS

Continuity of Interest. As mentioned previously, in addition to the aforementioned requirements set forth in the Code, there are certain principles laid down by the courts which must be complied with in order to obtain the desired tax-free treatment. The first such requirement is that of "continuity of interest." This test requires that in order to have a tax-free reorganization there must be a substantial continuing proprietary interest in the reorganized business by the parties to the reorganization. There is a continuity of interest where a substantial part of the consideration received constitutes an equity interest in the surviving corporation. The substantiality is measured by the value of the assets transferred, rather than by the total value of all assets of the surviving corporation. The requirement of a continuity of interest applies to all reorganizations, but is emphasized in the "B" and "C" types of reorganizations by the Code requirement that the transferor acquire solely voting stock of the transferee.

Business Purpose. The Supreme Court in the case of *Gregory v. Helvering*, 293 U.S. 465 (1935), laid down the now famous "business purpose" test. The Court, in this case, stated that a transaction, even though it literally complied with the requirements of the Code so as to qualify

as a tax-free reorganization, will not be considered as such if there is no "business purpose." Thus, there is a general requirement that a reorganization, in order to be tax-free, must have a bona fide corporate business purpose. The transaction cannot merely be a tax avoidance device.

In this regard it should be noted that if there is a substantial, valid business purpose, the tax-free nature of a reorganization will not be disregarded merely because there is also incidentally a tax saving motive. This falls under the general principle of tax law that, if there are two ways of accomplishing a result, the taxpayer is not obligated to choose the method which will result in the greater tax.

Plan of Reorganization. As mentioned above, an exchange is not tax-free, even though there is a reorganization, unless the exchange is made pursuant to a *plan* of reorganization. The plan of reorganization must be adopted by the proper officials of each of the participating corporations.

Party to a Reorganization. The term "party to a reorganization" includes a corporation resulting from a reorganization and both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another corporation. The corporation controlling the acquiring corporation is also a party to the reorganization when the stock of such controlling corporation is used to acquire assets of the acquired corporation. Also, a corporation remains a party to the reorganization although it transfers all or part of the assets acquired to a controlled subsidiary.

Filing Requirements. Every corporate party to a reorganization, must file as part of its tax return, for the taxable year in which the reorganization occurred, a duly certified copy of the Plan of Reorganization and a complete statement of all important facts in connection with the reorganization and the non-recognition of gain. All taxpayers, who receive stock, securities, or other property in a tax-free exchange, which is part of a reorganization, must attach a similar statement to their tax return. In addition to the information which must be supplied as part of the tax returns, each of the taxpayers involved must keep permanent records showing pertinent data regarding both the stock or securities given up and any stock, securities, other property or money received.

Advance Ruling Desirable. Although it is hoped that the above presentation makes reorganizations appear to be simple matters, the contrary is actually the truth. It should be realized that in an elementary presentation, all questions and aspects of reorganizations cannot be presented. Great care must be taken in setting up a transaction to qualify as a reorganization and in determining its tax consequences. The safest course of action to pursue in making sure of the tax-free nature of a transaction, is to secure a specific ruling, in advance, from the Commissioner of Internal Revenue stating the tax consequences of the proposed transactions. Such a ruling will be respected by the Internal Revenue Service as long as the completed transaction is substantially in accord with the facts stated in the ruling request.



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State and Local Taxation

NEW YORK STATE TAXATION

Conducted by PHILMORE H. FRIEDMAN, CPA

RECEIPTS FACTOR IN DETERMINING SALES ALLOCATION PERCENTAGE

In an earlier issue of this department there was a discussion of the new provisions of the sales allocation formula for New York companies doing business in other states, effective for taxable years beginning on or after January 1, 1961. The following chart has been developed as a convenient, time-saving reference record covering

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the salient features of the new law.

It should be noted at the outset that prior to the present change, the point of origin was the exclusive factor in determining the sales allocation percentage. Thus, receipts from sales of merchandise located in New York State, at the time of receipt of or appropriation to the order, were apportioned entirely to New York State. The point of destination (as well as the point of origin) is now a factor in determining the sales allocation percentage in New York.

Receipts from sales of tangible personal property are allocated as follows:

Location at time of receipt of or appropriation to order (point or origin)	Point of destination	Other pertinent information (where applicable)	Allocable Percentage to New York	
			Prior Law	New Law
(1) New York State	N.Y. State		100%	100%
(2) Outside of N.Y. State but not at any permanent or continuous place of business of taxpayer (e.g., public warehouse).	N.Y. State	Orders received or accepted at a per- manent or con- tinuous place of business in N.Y. State	100%	100%
(3) New York State	Outside of N.Y. State			
(4) Outside of N.Y. State at a permanent or con- tinuous place of busi- ness of taxpayer	N.Y. State	(3) To allocate, 100% must have reg- ular place of business out of state other than statutory office. Zero	100%	50%
				50%

Location at time of receipt of or appropriation to order (point or origin)	Point of destination	Other pertinent information (where applicable)	Allocable Percentage to New York	
			Prior Law	New Law
(5) Outside of N.Y. State but not at any permanent or continuous place of business		Order received or accepted at a permanent or continuous place of business outside of N.Y. State	Zero	50%
(6) Outside of N.Y. State but not at any permanent or continuous place of business of taxpayer (e.g., public warehouse).	N.Y. State Outside of N.Y. State	Orders received or accepted at a permanent or continuous place of business in N.Y. State	100%	50%

NOTES

(a) In Items (1) and (3) it is of no importance whether the corporation has a permanent or continuous place of business in New York State.

(b) An order is deemed received or accepted in New York if it has been received or accepted by an employee, agent, agency or independent contractor chiefly situated at, connected with by contract or otherwise, or sent out from a continuous place of business of the corporation within New York State.

(c) A permanent or continuous place of business has been defined as any bona fide office (other than a statutory office), factory, warehouse or other space outside New York, continuously maintained, occupied and used by the corporation in carrying on its business in its own name in a regular and systematic manner through its regular employees regularly in attendance.

Let us now pose a hypothetical situation to illustrate how the new legislation affects Corporation X. X Corporation has a factory, and a sales and executive office in New York; its own warehouse in Ohio; and a sales office in Connecticut at which orders are received and accepted. In addition, the company uses many public warehouses outside of New York from

which merchandise is shipped directly to customers.

Referring to the chart we can readily determine how the corporation's receipts should be allocated.

Under *prior law* the sales allocation was as follows:

(a) All shipments to customers from the New York factory were allocable entirely to New York (Chart items 1 & 3).

(b) All shipments to customers from the Ohio warehouse were entirely excluded from New York receipts (Chart item 4).

(c)(1) Shipments from the public warehouse were allocable to New York if orders were received or accepted in New York (Chart item 2).

(2) Shipments from the public warehouse were allocable outside of New York if orders were received or accepted in Connecticut (Chart item 5).

Under *current law* the sales allocation is as follows:

(a)(1) Shipments from the New York factory to customers in New York are fully allocable to New York (Chart item 1).

(2) Shipments from the New York factory to customers outside of New York are 50% allocable to New York (Chart item 3).

(b)(1) Shipments from the Ohio warehouse to customers outside of

New York are entirely excluded from New York receipts.

(2) Shipments from the Ohio warehouse to customers in New York are 50% allocable to New York (Chart item 4).

(c) In determining the sales allocation percentage where the merchandise is shipped from the public warehouses located outside of New York (a regular place of business but not a permanent or continuous place of business of taxpayer) the place where the orders are received or accepted is an important factor.

(1) Shipments to customers in New York are allocable 100% to New York if the orders are received or accepted in New York (Chart item 2). If the orders are received or accepted in the Connecticut sales office, then they are only 50% allocable to New York (Chart item 5).

(2) Shipments to customers outside of New York are allocated 50% to New York if the orders are received or accepted in New York (Chart item 6). If the orders are received or accepted by the Connecticut sales office then they are not allocable to New York at all.

SALE OF PROPERTY ACQUIRED FROM A DECEDENT

For federal estate tax purposes, the fair market value of a decedent's assets is determined at date of death, or, at the election of the estate fiduciary, on the alternate valuation date. The basis of the property for federal income tax—except a right to receive income in respect of a decedent under Code Sec. 691—is the fair market value used for valuation in the federal estate tax return. Under the New York Estate Law, the decedent's property is valued at fair market value at date of death; there is no provision authorizing an election to use an alter-

nate valuation date. Thus, it is common for property to have one basis for federal tax purposes and another for New York tax purposes.

In the event of a sale, the determination of the New York taxable income requires extra consideration. Lloyd Shapiro, CPA, a member of our Society's Committee on State Taxation points out how to compute the State tax in such cases, by a permissible adjustment of the federal adjusted gross income to arrive at state taxable income. The adjustment provided for is a reduction of the Federal adjusted gross income for that portion of any gain (limited to the amount of the gain) resulting from the sale or other disposition of property, having a higher adjusted basis for New York income tax purposes than for Federal income tax purposes as of December 31, 1959 (for calendar year taxpayers) or the last day of the 1959-1960 fiscal year (for fiscal year taxpayers). If the gain for Federal income tax purposes is taxable as long term capital gain, then the modification is limited to fifty percent of such gain. No adjustment is to be made where the basis for Federal purposes is greater than for New York purposes.

For purposes of illustration, let us assume that a taxpayer inherited stock from his father who died in 1956. For Federal Estate tax purposes the stock was valued at \$11,000 on the alternate valuation date. For New York Estate tax purposes the stock was valued at \$13,000. The stock is sold in 1961 for \$16,000. The gain for New York State income taxes is computed as follows:

Sale price	\$16,000.
Basis for Federal Income Tax	11,000.
Long-Term Gain for Federal Income Tax	5,000.

Included in Federal Adjusted Gross Income, @ $\frac{1}{2}$	2,500.
Excess of basis for New York Income tax purposes over Federal Income tax (\$5000-3,000)	2,000.
Modification adjustment for New York State Income tax, at $\frac{1}{2}$	1,000.
	Excess of basis for New York Income tax purposes over Federal Income tax 2,000.

The net effect, therefore, of the modification adjustment is to reduce the long-term gain includable in the New York adjusted gross income to \$1,500, the difference between the selling price (\$16,000.) and the New York State tax basis (\$13,000.), included at one-half thereof.

Assuming the same facts as above, except that the stock was sold for \$12,000, the modification adjustment will be computed as follows:

Sale price	\$12,000.
Basis for federal income tax	11,000.
Long-Term Gain for Federal Income Tax	1,000.
Included in Federal Adjusted Gross Income @ $\frac{1}{2}$	500.

(Gain cannot be reduced below zero)

If the property were sold for less than the Federal basis, resulting in a loss, no adjustment is provided for increasing the loss deduction for New York State income taxes. The same computation would be made if the property was depreciable property that had a higher basis for Federal than for New York State income taxes. However, the New York basis of the property would have to be reduced for depreciation that would have been allowed for 1958, even though no New York State income tax return was filed because of the tax cancellation.

It should be noted that the basis of property acquired by bequest or devise after December 31, 1959 is the same for New York State income tax as for Federal income tax even though different values were used in the estate tax returns. The modification adjustments do not apply to property acquired after such date.

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MUNICIPAL AND LOCAL TAXATION

Conducted by ROBERT I. EDELSON, CPA

CITY OF BUFFALO REAL ESTATE TAX

It has recently been held that a building erected by a private firm under a contract with the Atomic Energy Commission, a Federal Agency, was exempt from the Buffalo realty tax since the United States had become the beneficial owner of the property on the date as of which the taxable status was determined, in this case December 1, 1957. (13 A.D.2d, 154). A similar rule would probably prevail in New York City and elsewhere in the State.

NEW YORK CITY AMUSEMENT TAX

The Comptroller of the City of New York has issued Bulletin 1961-62, effective October 23, 1961, pertaining to the tax on admission charges to dramatic and musical arts performances. This tax has been repealed by Local Law 72, 1961, applicable to any charge paid on or after September 1, 1961 for admission to a performance occurring on and after October 1, 1961.

However, where the tax has been included in any charge which has been paid on and after September 1, 1961, for admission to a performance occurring on and after October 1, 1961, the

recipient shall include the amount of such charge in its return and pay the tax collected thereon to the City Treasurer, unless such recipient has previously refunded the tax to the patron.

The law defines a dramatic or musical arts admissions charge as follows:

"Any admission charge paid for admission to a theatre, opera house or concert hall for a live performance or for choreographic works of a dramatic character, or for a musical perform or concert (vocal, instrumental, or both). Performances and concerts, as used in this definition, shall not include circuses, ice shows, aqua-shows, or motion pictures; performances of any kind in a roof garden, cabaret or other similar place; or a musical performance, whether or not denominated as a concert at which patrons are permitted to engage in dancing."

NEW YORK CITY GROSS RECEIPTS TAX DUE DATE

A letter of the Special Deputy Comptroller outlines the privilege periods, basic periods, and due dates of returns under the gross receipts tax, of a corporation organized on May 1, 1960, which did not begin to do business until December 1, 1960. The periods and due dates are as follows:

Privilege Periods	Basic Periods	Due Dates of Returns
7/1/60- 6/30/61	12/1/60- 6/30/61	8/ 1/61
7/1/61-12/31/61	1/1/61-12/31/61	5/15/62
1/1/62-12/31/62	1/1/62-12/31/62	5/15/63

Accountants may use this as a guide in making determinations for other periods.

SODAS, SANDWICHES, AND THE NEW YORK CITY SALES TAX

Maxwell Davidson, member of our

Society's Committee on Municipal and Local Taxation, points out some of the problems involved in sales of soda and sandwiches.

Sodas and sandwiches are common items. One would not be aware just by looking at them that they could per-

plex their seller to figure his proper sales tax liability.

Where the consumer drinks a soda, and only a soda, on the seller's premises, the seller must collect a sales tax of 3% of the price of the soda. If while drinking this soda, the consumer also eats a sandwich and the combined soda and sandwich charge totals

ROBERT I. EDELSON, CPA, is chairman of our Society's Committee on Municipal and Local Taxation. He is a partner in the firm of Emanuel M. Edelson & Co.

less than \$1.00, the seller does not collect any sales tax, neither for the soda nor for the sandwich. However, if the soda and sandwich charge totals \$1.00, or more, then the seller collects a sales tax of 5% on both of these items. Yet, if instead of eating the soda and sandwich on the seller's premises, the consumer takes them with him to his office, then regardless of the total price of the soda and sandwich, the seller collects a sales tax of 3% of the price of the soda but collects no sales tax on the sandwich.

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Accounting and the SEC

Conducted by LOUIS H. RAPPAPORT, CPA

INCREASING IMPORTANCE OF THE SUMMARY OF EARNINGS

In the early days of the 1933 Act the only registration form was Form A-1, but it was followed by Form A-2, Form E-1, and other forms. We mention these forms only because they no longer exist, having been superseded by the forms now in use.

Just as there have been evolutionary changes in the forms themselves, there have been important and significant changes in the financial requirements. We believe it is generally agreed that the most important single financial statement in a prospectus (which is the heart of a registration statement) is the summary of earnings.

In view of the over-riding importance of the summary of earnings, it is difficult to believe that there was a time when it was not required by the SEC. The SEC has always required an income statement for at least three years (if the registrant had been in business that length of time) but not a summary of earnings for a minimum period of five years as is now required. How did it become an SEC requirement?

If memory serves us, it has always been a requirement for registrants to set forth certain materially important developments in the five years preceding the filing of a registration statement. Although there was no require-

ment that earnings of this period be summarized under this heading, it became common practice to include in the prospectus an earnings summary for that period. Whether the furnishing of the summary was at the suggestion of registrants, underwriters, or their counsel, we are not prepared to say. It is a fact, however, that the practice of including earnings summaries, even though not called for by the SEC, became so widespread that a prospectus without a summary was the exception, not the rule. Later, when the SEC amended its financial requirements so as to call for a summary, this SEC move simply formalized what had become good practice.

As an indication of the importance which the SEC attaches to the summary of earnings, we think it is fair to say that currently the number of deficiencies cited by the SEC in relation to such summaries exceeds those cited in relation to all other financial statements combined. This does not mean that summaries are carelessly prepared by registrants or inadequately reviewed by their certifying accountants. It simply reflects the importance which the SEC examiners attach to the summary.

In connection with the summary, the SEC's instructions provide that "whenever necessary" information or explanations "of material significance to investors in appraising the results shown" shall be reflected; if the information or explanations are set forth

LOUIS H. RAPPAPORT, CPA, a partner in the firm of Lybrand, Ross Bros. & Montgomery, CPAs, is the author of SEC ACCOUNTING PRACTICE AND PROCEDURE.

elsewhere in the prospectus, cross reference is permitted. This is the only place in the financial section of the registration document where an instruction of this kind appears. If, for example, the earnings reflect the results of unusual conditions, or in certain years include significant nonrecurring items of income or expenses, an appropriate disclosure of such conditions or items must be made. Where the summary reflects operations of a predecessor, or where there have been violent or radical changes in the enterprise, appropriate disclosures or adjustments may be required, or the summary may, in fact, be entirely deleted. If a predecessor operated as a partnership, it is ordinarily necessary to indicate in some way the adjustments that would be required to place the partnership income on a corporate basis. If there have been substantial changes in sales or operating revenues,

up or down, the reasons for the change will have to be considered and, possibly, disclosed. Similarly, if there have been significant changes in the gross profit percentage, the reasons underlying the changes will have to be looked into and consideration given to the necessity for their disclosure in the prospectus.

Because of the importance which investors attach to the summary, it is a statement which deserves meticulous care in its preparation. As originally filed with the SEC, the summary may not have in it everything that the SEC examiners would like to see, but if there is an omission, it is not because the interested persons were not trying. Based on our experience, we think it is safe to say that this is the financial statement upon which the greatest attention is focused—by registrants, their independent accountants, underwriters, and lawyers.

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Administration of A CPA Practice

Conducted by MATTHEW P. GERAGHTY, CPA

A MANUAL PROCEDURE FOR ACCUMULATING AND BILLING CLIENT CHARGES

Accounting firms on the accrual basis, either for tax purposes or internal reporting purposes, are faced with the problem of developing a speedy, accurate and economical procedure for maintaining client accounts receivable, including both billed and unbilled charges, the latter usually being referred to as work-in-process.

There seems to be little general agreement as to the best method of accomplishing this purpose. Some firms have used electrical accounting machine systems only to discard them in favor of a completely manual system. Others use a combination of methods—electrical accounting machines to accumulate the monthly detail charges for clients with manual posting to a combined billed and unbilled accounts receivable ledger card.

The system described in this column is used by J. K. Lasser & Co., a firm with approximately 150 partners and employees. The forms used and the

information on which this description is based were made available by Mr. James B. Kobak, a partner of J. K. Lasser & Co. The entire system is maintained on a completely manual basis.

The following forms are used in the system:

Exhibit 1—Charge categories (assignment codes)

Exhibit 2—Job Ticket—Partners and staff members

Exhibit 3—Job Ticket—Typing and miscellaneous service departments

Exhibit 4—Combined billed and unbilled accounts receivable (client ledger card)

Exhibit 5—Billing instructions

Additional forms used include time and expense reports which are of the standard type and for that reason are not illustrated here.

Time and expense reports. The starting point, as usual in the accumulation of client charges, is the preparation of the time report, a monthly form in this case. A separate line of the time report must be used for each different category of work performed for a client. The various categories of

MATTHEW P. GERAGHTY, CPA, is Chairman of the Committee on Administration of Accountant's Practice of The New York State Society of Certified Public Accountants. He is a partner in the firm of Alexander Grant & Company, CPAs.

work are indicated in Exhibit 1. Thus, if Federal income tax returns are prepared for a client, the job description would be 2-1, Federal Income Tax Returns. Such information is daily in each individual's diary to facilitate the preparation of the time reports and job tickets referred to in the following paragraphs.

In addition to the time report, a job ticket, Exhibit 2, is prepared for every line item on the monthly time report. Therefore, if an individual has performed tax services within each tax category listed in Exhibit 1, there will be six job tickets submitted with the monthly time report. However, it is only rarely that a man has more than one ticket for any client in any one month. Only descriptive and quantitative information is recorded on a job ticket by a partner or staff member.

The typing department uses a special type of job ticket, as indicated in Exhibit 3, which provides for charging clients according to the number of pages typed for each client. The pages are charged at different rates depending upon the complexity of the material typed.

The third source of client's charges is the expense voucher, with a separate voucher for each client listed on the time report.

Accounting department procedures. Time reports, job tickets and expense reports must be submitted to accounting department by the 5th day of each month. The accounting department then performs the following steps in developing the work-in-process, or unbilled client receivable balances and the billed receivable balances:

- Footer and cross footer the hours on time reports.
- Extends total hours on each time report at the individual's standard billing rate and enters this amount on the face of the time report.

- "Agrees" total hours on job tickets with total hours on each time report.
- Extends hours on job ticket at the individual's standard billing rate.
- Tapes total dollar amount on job tickets and "agrees" this amount with the total amount of billed chargeable time on the time reports.
- Post client's expenses from expense reports to appropriate job tickets.
- Sorts job tickets by client, tapes the job tickets for each client, obtaining subtotals for each major charge category, such as audit, tax preparation, special accounting, etc.
- Posts the total dollar amount of each major charge category to the respective column of the client's combined billed and unbilled receivable ledger card, Exhibit 4, which is prepared in duplicate.
- Posts invoices for monthly billings to the respective ledger cards—entering the billings in both sections of the card, as a credit in the billed column, of the section headed Charges (Unbilled Receivables) and as a charge in the total billed column of Bills section (Billed Receivables) of the client's ledger card.
- Posts cash collections to cash receivable column of the Bills section of client's ledger card.
- Proves the total of the billed and unbilled receivable balances against the related general ledger control account balances at the close of the month.

Billing procedures. Upon completion of step 11 indicated above, the duplicate copy of the client's ledger card, together with the job tickets comprising the balance of work-in-process, are submitted to the partner in charge of the account. He prepares the Billing

Instructions form (Exhibit 5), used as a basis for billing work-in-process in the account at the close of the month. Space is provided on the form under each major work category for the exact wording to be used on the bill itself.

If the client is charged on a per diem basis and billing is done on a monthly basis, the client ledger card and job tickets provide the partner with sufficient information for preparation of the Billing Instructions form. However, where accounts are billed only upon completion of the assignment, a recapitulation of the job ticket hours according to assignment code,

may be necessary to provide adequate information for intelligent billing purposes.

The foregoing system has been in use for some time and has proved to be quite satisfactory. Client ledger cards are made available to the partner for billing purposes within two weeks following the close of the month. In addition, the manual system has proved to be more economical than in a machine system wherein source documents were converted into punched cards by a local service bureau, with the resulting machine listings serving as the client ledger cards.

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EXHIBIT 1

J. K. LASSEN & CO.

CHARGE CATEGORIES— HANDY REFERENCE CARD

1. Audit
 - 1-0 Audit
2. Tax Preparation
 - 2-1 Federal Income Tax Returns
(Non-Individual)
 - 2-2 State Income or Franchise Tax Returns
(Non-Individual)
 - 2-3 Sales and Gross Receipts Tax Returns
 - 2-4 All Other Returns (Non-Individual)
 - 2-5 Individual Income Tax Returns
 - 2-6 Gift & Estate Tax Returns
3. Special Accounting Services
 - 3-1 SEC Work
 - 3-2 Audits of Profit Sharing Trusts
 - 3-3 Bookkeeping Aid
 - 3-4 Renegotiation
 - 3-5 All Other
4. Tax Examination
 - 4-1 Federal Income Tax Returns
(Non-Individual)
 - 4-2 State Income or Franchise Tax Returns
(Non-Individual)
 - 4-3 Sales and Gross Receipts Tax Returns
 - 4-4 All Other Corporate Returns
 - 4-5 Individual Tax Returns
5. Pension, Profit Sharing and Compensation Plans
 - 5-0 Pension, Profit Sharing and Compensation Plans
6. Estate Planning and Estate Work
 - 6-0 Estate Planning and Estate Work
7. Management
 - 7-1 Systems Installations
 - 7-2 Management Studies
 - 7-3 Budget Installations
 - 7-4 Publishing Studies
 - 7-5 Statement Planning unless part of Regular Audit Fee
 - 7-6 Printing Studies
 - 7-7 Statistical
 - 7-9 Other
8. Financing—New Ventures—Valuations—Business Purchases and Sales
 - 8-1 Financing and Refinancing
 - 8-2 New Ventures
 - 8-3 Valuations
 - 8-4 Business Purchases
9. Tax Consultation, Rulings and Cases
 - 9-1 Tax Consultation
 - 9-2 Protests and Appellate Division Costs
 - 9-3 Rulings
 - 9-4 Court Cases
 - 9-5 Washington Conferences, etc.
 - 9-6 Use only when instructed by a partner
- X. Association Service and Conventions

EXHIBIT 5

J. K. LASSEN & CO.

BILLING INSTRUCTIONS

Client Name	
1. Audit*	\$
2. Tax Preparation*	\$
3. Special Accounting Services*	\$
4. Tax Examination*	\$
5. Pension, Profit Sharing & Compensation Plans*	\$
6. Estate Planning & Estate Works*	\$
7. Management*	\$
8. Financing—New Ventures—Valuations — Business*	\$
9. Tax Consultation, Rulings & Cases*	\$
10. Others	\$
TOTAL \$——	
Write-On	\$
Write-Off	\$
Transfers	\$

Signature _____ Date _____

* Write in the exact wording you wish to have appear on the bill.
(Width Contracted)

CODE NO.

MONTH

1961

CLIENT

KIND OF JOB

HOURS

DO NOT WRITE HERE

Exhibit 2

NAME OF STAFF MEMBER

(USE TYPEWRITER OR PEN ONLY — NO PENCIL)

CODE NO.

MONTH

1961

CLIENT

Pages

Pages

DO NOT WRITE HERE

Exhibit 3

CONTINUED ON NEXT PAGE

BILLING INSTRUCTIONS

MAGAZINE

VITRINATE

WRITING AND OFFICES

TOTAL W/O

BALANCE

TOTAL

60

FOWD

Payroll Tax Notes

Conducted by SAMUEL S. RESS, CPA

UNEMPLOYMENT INSURANCE BENEFIT PAYMENT PRACTICES

The Unemployment Insurance Law was enacted to provide some income during limited periods of unemployment for persons who rely on wage earning employment and are unemployed due to conditions in the labor market and through no fault of their own. Accountants should know about the "Methods Used In Claims Determination."

Claimant's Application. The claimant is interviewed at the local office. All possible disqualifying information including that supplied by the employer and other workers is discussed with the claimant when there is a question as to his eligibility. If no question is raised or no information is made available to the local office by the employer or other sources of information, then benefit applications which appear to be in order on their face are approved. If at a later date information comes to the unemployment insurance office which indicates that a misrepresentation was made by a claimant or others, the penalty provisions of the statute are invoked, even though no benefit payment was actually made.

Notice to Employers. Pertinent in-

SAMUEL S. RESS, CPA, is engaged in public practice in New York City. Dr. Ress was formerly a member of our Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance. He is a member of the Committee on Municipal and Local Taxation.

formation from employers is obtained by the local office through written responses to the queries contained on the Notice To Employers Of An Original Claim For Benefits (Forms L.O.12.11 or L.O.12) or when the Notice To Employers Of Benefit Payments (Form I.A.96) is sent to the employer after benefit payments are made for each week. Employers should supply all pertinent information as a regular routine. This will protect their merit-rating status in the event of possible disqualifying conditions. Whenever employer information suggests potentially disqualifying circumstances the local office is required to make an investigation. The claimant is interviewed and the case is fully explored before a disposition is made.

Claimant's Availability For Work. Benefit claimants are required to register for work at the Placement Office, and failure to accept a referral by the New York State Employment Service may indicate that the claimant was unavailable for employment and therefore disqualified from receiving benefits.

An availability questionnaire on which the claimant lists the contacts made by him in his required independent hunt for a job, is another device used to determine whether the claimant is actively seeking employment while collecting benefits.

A claimant may be available for work even though he limits the kinds of jobs he will accept. Limitations

which are not reasonable in the light of the claimant's former work history and the genuine prospects of employment on the claimant's terms should be closely examined. For example, when a claimant is laid off subject to recall or he has a firm commitment of new employment at a stated date, he must nevertheless accept suitable interim employment.

Other situations which raise the issue of availability include removal to another community where there are no job opportunities in the claimant's occupation, seasonal workers and pregnancy and child care problems. A pregnant claimant, particularly if she left a job voluntarily, is presumed unavailable for employment. This presumption may be overcome only by convincing evidence supplied by the claimant. The State Labor Law prohibits employment in factories or mercantile establishments for four weeks after childbirth. Claimants in these occupations are therefore held to be unavailable for work during these four weeks regardless of their apparent good physical condition or willingness to work.

Availability of Retired Persons for Work. Factors used in determining availability for work of retired persons are as follows:

- Was the retirement from his last employment a mandatory or a voluntary separation?
- The willingness of the retired claimant to accept such suitable employment as is obtainable in the current labor market in the light of conditions surrounding the employability of older workers.
- Physical capacity of the claimant to do the kind of work for which he is otherwise qualified.
- The reasonableness of the restrictions imposed by the claimant as to wages, type of work, location, trav-

el, means of transportation, hours, etc.

- The kind and extent of the efforts made by claimant to secure employment.
- The amount of pension and old-age benefits received and their effect on a genuine desire to work, the conditions of continued receipt of such payments and the willingness of claimant to forfeit the entire amount or any part of other benefits, if necessary, to accept employment.

Voluntary Leaving Of Employment Without Good Cause.

A claimant who voluntarily leaves employment (a) due to marriage, (b) to join spouse in a new locality, or (c) without good cause, is disqualified until after reemployment on at least three days in each of four separate weeks or until wages of at least \$200 have been earned.

Circumstances which require inquiry to determine whether good cause for quitting employment, include:

- Wages and other working conditions.
- Promises concerning wage increases and promotions.
- Prospects of other employment, or assignment to other work.
- Transportation problems and distance from work.
- Health; safety; pregnancy; relations and compatibility with employer and co-workers.
- Overtime requirements; compliance with union requirements; violation of terms of employment or discrimination.

The accountant should be aware of some of the many available valid areas in which unjustified benefit charges to the employer account may be prevented.

Claimants in Special Categories.

Claimants in special categories are giv-

en special attention. The local office should be notified by the employer about the existence of circumstances such as arise among pensioners, older workers, pregnant women, seasonal workers, or ill workers and if doubt exists as to the claimant's readiness, willingness or ability to work. These persons may be entitled to one or more of some of the other welfare benefits presently provided by statute or union contract, but they may not qualify for unemployment insurance benefits.

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Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary

—Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

ONCE A COLLAPSIBLE, ALWAYS A COLLAPSIBLE

In a decision which could have far reaching results under the 1954 I. R. C., although it was decided under Section 117(m) of the 1939 I. R. C., the 5th Circuit Court of Appeals has apparently closed all possibilities of escaping penalty once a corporation has qualified as "collapsible."

In 1949, Mr. Heft organized G Corporation and became its sole stockholder. G Corporation purchased 53 unimproved lots in September 1950 and constructed dwellings on each lot. Subsequently it sold 16 properties by January 21, 1952, realizing thereon 17% of the taxable income to be derived from the sales of the total properties. On the same date the directors commenced voluntary liquidation proceedings, and Heft, as liquidator, transferred to himself 26 of the remaining properties. During the next 4 months, G Corporation sold the remaining 11 properties, and the income realized by the corporation on these sales was 34% of the total income realizable. The liquidation was completed in October 1952 by distributing all of the remaining cash in the corporation to Heft.

The Commissioner and the Tax

Court treated the gains on the entire distribution of property and cash as ordinary income rather than capital gains, on the grounds that G was a collapsible corporation.

The Circuit Court of Appeals considered the taxpayer's contentions that (1) the realization of 17% of the taxable income to be derived from the property represented a *substantial* part of such income; and (2) even if the 17% earned before the first distribution is not so considered, the corporation continued operations and, before its termination, realized 51% of its income and paid taxes thereon. Thus, if the corporation had withheld the initial distribution until its final liquidation it would not have qualified as a collapsible corporation.

Commenting that in an earlier case before the same Court (*Com. v. Kelley*, 4/2/61), it had ruled that a realization of 33% met the "substantial" requirement, the Court held that 17% was not "substantial". This, of course, could lead to the somewhat absurd situation where, for example, 24.999% is not "substantial" and 25.000% is "substantial."

With regard to the taxpayer's second contention, the Court ruled that if a corporation meets the definition of

"collapsible" it is a "collapsible corporation" and that therefore all distributions made by it are to be treated as those of a "collapsible corporation." In the instant case all of the distributions were taxable under the collapsible rules since a distribution was made prior to the realization by G Corporation of more than 17% of realizable taxable income; and Sec. 341(b)(1)(A), defining "collapsible corporation," provides that the definition is met if there is "a distribution to its shareholders, before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property . . ." Thus, since G Corporation qualified as "collapsible" because of its first distribution, its subsequent realization of taxable income does not remove it from the "collapsible class."

This must also lead to the conclusion that if a corporation once meets the "collapsible" definition, all of its subsequent distributions, or, of course, any sale or exchange of stock by its shareholders, even after the lapse of the requisite 3-year holding period (or any other action which would statutorily exclude the corporation from being a "collapsible" corporation) would be taxable to the extent of gain as ordinary income. (*G. A. Heft et al v. Com.*, CA-5, 9/15/61, aff'g 34 TC 86)

ACCUMULATED EARNINGS TAX: AN IMPORTANT DECISION

In the 1954 Code, Congress added several provisions to the section deal-

ing with the penalty tax on unreasonable accumulation of earnings. Among them was a provision which would act to shift, from the taxpayer, the burden of proving that an accumulation of earnings was for reasonable needs of the business, to the government, who must prove that they were excessive and unreasonable. The burden of proof is effectively shifted if the taxpayer, in response to official notice from the Commissioner, submits a statement setting forth the grounds on which it relies to establish the reasonableness of the accumulation of earnings. The burden also shifts to the Commissioner if he fails to send the required notice to the taxpayer (Sec. 534(b) and Regs. Sec. 1.534-2).

Although the above changes were intended to aid taxpayers (in fact, the "burden of proof" section was made retroactive to the 1939 Code), the purpose appeared to be thwarted by the decisions of the Tax Court and the 7th Circuit Court of Appeals in *Pelton Steel Casting Co. v. Com.* (CA-7, 1958, 251 F(2d) 278 aff'g 28 TC 153, Cert. den. 356 U.S. 958) and cases which followed it. Holding that the "general rule," both under Sections 102 of the 1939 Code and 532 of the 1954 Code, imposed the tax upon any corporation formed or availed of to avoid income tax to its shareholders by failing to distribute earnings, the aforesaid courts decided that the question of whether the accumulation was reasonable in view of the needs of the business was, in effect, of secondary importance and not controlling. Hence, if the taxpayer failed to disprove that the corporation was "availed of" for the tax benefit of its stockholders, it had lost its case even though the Commissioner failed to prove unreasonable accumulation.

This position has been attacked by a recent decision of the 2nd Circuit

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Court of Appeals, reversing the Tax Court. The Court said that *any time* a corporation failed to distribute dividends, its stockholders' taxes would be less than if there had been a distribution. It disagreed with the Treasury's contention that a closed corporation is automatically availed of, if dividend distributions are not made to the stockholders. It stated that Congress' intention was that the tax be only against corporations that accumulated earnings beyond their reasonable business needs *in order to reduce stockholders' taxes*; that only such corporations were really being "availed of." Therefore, said the Court, the issue of whether the accumulation was reasonable or not, in view of business needs, is of prime consideration, and it follows that the question of which party has the burden of proof on this issue is of extreme significance.

In the instant case, the 2nd Circuit found that the taxpayer had effectively shifted the burden of proof on the reasonable needs question to the Government, by submitting a 24-page statement showing the facts and rationale upon which it relied. (The Tax Court in line with its former position, had held that there was no need to consider the "burden of proof" issue.) The Court of Appeals then held that the Government had failed to carry the burden of proof as to unreasonable

accumulation. (*Gsell & Co. Inc. v. Com.*, CA-2, 9/22/61.)

Thus, the 2nd Circuit has now joined the 1st Circuit (see *Young Motor Co. Inc. v. Com.* 281 F(2d) 488, CA-1, 1960 rev'd 32 TC 1336) in holding that reasonable business needs *must* be considered in an accumulated earnings case and that the burden of proof *must* be shifted to the Government in any case where the taxpayer puts forth the statement of facts upon which he relies.

NEW PROCEDURE FOR FILING PROTESTS

Commissioner Mortimer M. Caplin of the U.S. Internal Revenue Service announced a change in procedure for bringing certain tax cases before the Appellate Division.

The Commissioner said that written protests which taxpayers are required to file with the District Director to bring unagreed tax cases before the Appellate Division may now be certified as true under the penalties of perjury. Formerly such written protests had to be filed under oath.

This relaxing of the requirements is effective immediately and applies to written protests on unagreed income, excess profits, estate and gift tax cases which are not docketed in the Tax Court and to unagreed employment and certain excise tax cases. (T.I.R. 343, 10/31/61.)

COMMENTARY

SUBCHAPTER S—"CLASSES OF STOCK"

One of the requirements which must be satisfied so as to come within the definition of a "small business corporation", and thus be eligible to file an election not to be taxed as a corporation pursuant to Subchapter S, is the existence of only one class of stock (Section 1.371(a)(4). Prior to the

issuance of regulations, the Internal Revenue Service held that this requirement was satisfied if a corporation had outstanding a Class A common stock and a Class B common stock with equal dividend rights, equal liquidation preferences, and equal voting rights "except that each class has the right to elect half the members of the

Board of Directors" (T.I.R. No. 113). Such a position might have been interpreted to mean that there would be considered to be one class of stock only if each class can elect half the Board. However, the regulations go further by holding that "if two or more groups of shares are identical in every respect except that each group has the right to elect members of the Board of Directors in a number proportionate to the number of shares in each group, they are considered one class of stock" (Regulations Section 1.1371-1(g)).

Does this mean that, so long as the "proportionate" requirement is met, the privilege of utilizing Subchapter S is available and no importance is attached to the breakdown of stock ownership within a particular group? For example, assume X Corporation has outstanding a Class A common and a Class B common which are identical in every respect except voting rights. The Class A common, with 200 shares outstanding, can elect 4 Directors while the Class B common, with 150 shares outstanding, can elect 3 Directors. This proportion, of course, clearly comes within the regulation. Assume further that the ownership of the Class A common and the Class B common is as follows:

Class A Common

Shareholder #1	.....	120 shares
Shareholder #2	.....	40 shares
Shareholder #3	.....	40 shares
<hr/>		200 shares

Class B Common

Shareholder #4	.....	125 shares
Shareholder #5	.....	25 shares
<hr/>		150 shares

Does the fact that shareholder #1 has the power, by his majority control of the Class A common, to elect four out of seven members of the Board of Directors (notwithstanding his lack of majority ownership of all of the stock of the corporation, and also notwithstanding the ownership by shareholder #4 of a large number of shares) mean that there are considered to be two classes of stock for purposes of Subchapter S? It does not appear so. The regulation quoted above specifically states that there is only one class of stock so long as, to use our example, the Class A common, *as a group*, and the Class B common, *as a group*, can elect directors "in a number proportionate to the number of shares *in each group*." Since this proportion requirement has been satisfied (200 is to 150 as 4 is to 3), the Subchapter S election should be available.

It would appear, therefore, that such an arrangement whereby voting control is insured for a minority stockholder need not automatically result in the corporation's falling outside the scope of Subchapter S.

POSSIBLE ADDITIONAL DEDUCTION FOR NEW YORK CITY GROSS RECEIPTS TAX

During 1961, amendments were made to the New York City General Business and Financial (Gross Receipts) Tax Law which changed the privilege period for which the tax is paid. Previously, the gross receipts of

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a calendar year normally measured the tax for the privilege period beginning July 1 of that year and ending the following June 30. For example, the tax which was due on May 15, 1961 was based upon receipts for the calendar year 1960, but covered the privilege period from July 1, 1960 to June 30, 1961.

Commencing in 1962, the calendar year will be both the base period and the privilege period. For example, the tax to be paid on May 15, 1963 will be based upon receipts for the calendar year 1962 and will cover the privilege year of 1962. In order to effect this transition, the law provides that the tax to be paid on May 15, 1962 will be based upon receipts of the calendar year 1961, but will cover the privilege period from July 1, 1961 to December 31, 1961.

For accrual basis taxpayers, the New York City gross receipts tax accrues, and is deductible for federal income tax purposes, in the taxable year in which falls December 31, the close of the base period, (I.T. 3200, 1938-1 C.B. 145). Thus, in the case of a taxpayer employing the calendar year, the tax due on May 15, 1961 was accruable on December 31, 1960 and was deductible in full in the year 1960. Taxpayers employing this method of deducting the New York City gross receipts tax are not affected by the amendment in the New York City law.

However, many taxpayers have been deducting the gross receipts tax over the privilege period to which the tax applied, following the principles set forth in G.C.M. 24461, 1945 C.B. 111. A calendar year taxpayer following this method would have accrued as a liability at December 31, 1960 the full amount of New York City gross receipts tax to be paid on May 15, 1961, but would have deducted only 6/12ths of that amount in 1960 and would have deferred, for both book

and tax purposes, the remaining 6/12ths until 1961. (Such a taxpayer would have also deducted in 1960 the remaining 6/12ths of the tax paid on May 15, 1960.) Subsequent rulings (for example, Revenue Rulings 60-133 and 57-539) reaffirm that this practice constitutes "a method of accounting."

Accordingly, a calendar year taxpayer who has been deducting the New York City gross receipts tax proportionately over the privilege period will for the year 1961 have a deduction equal to the sum of 6/12ths of the tax paid on May 15, 1961, plus the entire amount of tax to be paid on May 15, 1962. In other words, the deduction for 1961 will be measured essentially by the receipts of 18 months.

This principle also has application to fiscal year taxpayers who have employed the accounting method of deducting the New York City gross receipts tax proportionately over the privilege period.

PERIOD OF LIMITATION ON NET OPERATING LOSS CARRYBACK REFUNDS

Taxpayers, in filing claims for refunds, should not rely on a waiver of the statute of limitation given for the year in which a net operating loss carryback is deducted. Because of the uncertainty as to the effect of such a waiver, it is recommended that taxpayers file claims for loss carryback refunds no later than the fifteenth day of the thirty-ninth month after the close of the *loss year*. A claim will also be timely if it is filed after such date but no later than six months after the expiration of a waiver given for the year of the *loss*, not the year to which the loss is carried back.

For example, a calendar year corporation sustained a loss in 1958 which it can carryback and deduct against profits realized in 1955. The 1955 return is still (as of December

1961) under examination by the Internal Revenue Service pursuant to a waiver of the statute of limitations for 1955, which will not expire until June 30, 1963. Under Section 6511(c), it appears that the corporation has until December 31, 1963 (six months after the expiration of the waiver) in which to file a claim for refund for 1955. However, under Section 6511(d)(2), the corporation has only until March 15, 1962 (fifteenth day of the thirty-ninth month after the end of 1958—the loss year) in which to file a claim for refund based on a net operating loss carryback. Which date is controlling for filing the claim for refund—December 31, 1963 or March 15, 1962?

There is no clear cut answer to this question. Such authority as there is indicates that March 15, 1962 is the controlling date. Reg. Section 301.6511(d)-(a)(1) provides in effect that a claim for a loss carryback refund must be filed by a corporation before the expiration of the later of the following two dates:

(a) The fifteenth day of the thirty-ninth month following the end of the taxable year (March 15, 1962); or

(b) Six months after the expiration date of a waiver of assessment filed with respect to the year of the net operating loss which resulted in the carryback.

Thus, according to the regulations, a waiver given for the loss year definitely extends the period for filing a carryback claim. However, the regulations, perhaps significantly, do not discuss the effect of a waiver given for the year of the loss deduction.

The Tax Court in *Claremont Waste Mfg. Co.*, 24 TC 1087 (1955), held that a waiver extends the statute of limitations only if given with respect to the year of loss. On appeal, however, the First Circuit, (238 F. 2d 741

(1956)), indicated that the waivers given with respect to the year of deduction extends the time for loss carryback refunds, although it affirmed the Tax Court's decision on other grounds.

In *Brad Foote Gear Works, Inc.*, 288 F. 2d 894 (1961), the taxpayer claimed a refund for 1944 excess profits taxes based on a carryback of a credit from 1946. While there are a number of complicating factors in that case that are not pertinent here, the Court of Claims did state:

"It is clear from the foregoing that the required claim for refund must be filed within 6 months after the expiration of the taxpayer's agreement extending the time of assessment for the year of net operating loss. The crucial factor here is that the plaintiff completely fails to meet this requirement. (Taxpayer) had an agreement with the Commissioner for the year 1944 but not for the year 1946, which is the year of the net operating loss."

Section 322, 1939 Code, involved in this case and Section 6511, 1954 Code, are similar with respect to this point. The Court of Claims also indicated its agreement with the Tax Court's holding in *Claremont Waste Manufacturing Co.*, noted previously, and its disapproval of the position of the First Circuit observing that the Circuit Court's comment was dictum.

In deciding this question, it should be noted that the caption to Section 6511(d)(2) reads "Special period of limitation with respect to net operating loss carrybacks." This caption could be construed to mean that the "special period" is the *only* period of limitation applicable to net operating loss carrybacks under the rule of statutory construction that a specific section of a statute controls over its subject matter in derogation of a general

section. On the other hand, it can be contended that Congress intended to extend, rather than limit, the time for filing claim for loss carryback refunds in Section 6511(d)(2), and therefore Section 6511(d)(2) cannot reduce the refund period otherwise applicable to a year of loss carryback deduction.

DIFFERENCES BETWEEN STATEMENTS AND TAX RETURN WHERE LIFO USED

A requirement for a taxpayer using the LIFO method of inventory valuation in his income tax returns is that the LIFO method must also be used in reports prepared for credit purposes or for shareholders (Reg. Section 1.472-2(e)). There are several instances in which the Service has permitted deviation from this rule.

For example, a taxpayer using LIFO is a subsidiary of a corporation which publishes consolidated financial statements, but the parent and subsidiary are filing separate income tax returns. The Service has permitted the subsidiary to continue the use of LIFO in its tax return even though in the published consolidated financial statements the subsidiary's inventory has

been adjusted and restated on a FIFO basis. A condition of this permission probably would be that the subsidiary furnish its parent with statements prepared on a LIFO basis. In addition, the subsidiary would not be permitted to furnish statements to creditors unless such statements were on a LIFO basis.

Another exception relates to the use of lower of cost or market in conjunction with LIFO. For income tax purposes this is not permitted, which would seem to preclude the use of market value, where less than LIFO, in financial statements. However, the regulation cited provides specifically:

"The taxpayer's use of market value in lieu of cost or his issuance of reports or credit statements covering a period of operations less than the whole of the taxable year is not considered at variance with this requirement."

It would appear that the use of market is not restricted to interim statements and that it also can be used in annual reports to stockholders.

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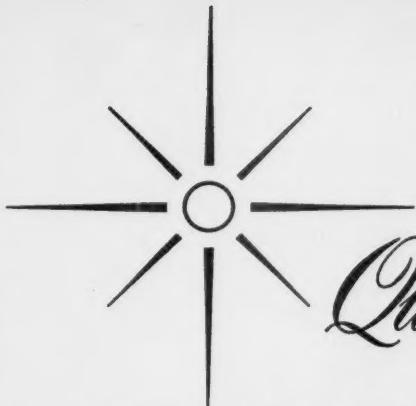
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